COMMENTS
to the
Federal Reserve Board

12 CFR Part 226
[Regulation Z; Docket No. R-1367]
Truth in Lending – Proposed Rule

by the National Consumer Law Center[1]
(on behalf of its low-income clients)
and for
the National Association of Consumer Advocates,
Consumer Action, Consumer Federation of America,
the National Fair Housing Alliance, and
the Center for Responsible Lending

December 24, 2009

The National Consumer Law Center (NCLC) submits the following comments on behalf of its low-income clients, as well as the National Association of Consumer Advocates, Consumer Federation of America, Consumer Action, the National Fair Housing Alliance, and the Center for Responsible Lending, to the Federal Reserve Board regarding the proposed rule resulting from the Board's comprehensive review of the Truth in Lending Act's (TILA) rules for closed end credit.

[1] These comments were written by NCLC attorneys Carolyn Carter, Alys Cohen, Andrew Pizor, Leah Plunkett, John Rao, Margot Saunders, Jon Sheldon, and Diane E. Thompson. Please note that NCLC has also submitted comments on the proposed rule regarding open end home secured credit or home equity lines of credit (HELOCs) under docket number R-1367. Because there is some overlap between the proposals for closed-end credit and HELOCs, as well as in our discussion of them, we have included a copy of our HELOC comments as Appendix I. for ease of reference. For each section, we have also identified the section in our HELOC comments which discusses the same or a similar topic.

ABOUT THE ORGANIZATIONS COMMENTING

The **National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (6th ed. 2007), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (4th ed. 2009), and *Foreclosures* (2d ed. 2007), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to address predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws.

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

Consumer Action (www.consumer-action.org) is a national non-profit education and advocacy organization that has served consumers since 1971. Consumer Action serves consumers nationwide by advancing consumer rights in the fields of credit, banking, housing, privacy, insurance and utilities. Consumer Action offers many free services to consumers and communities, including an assistance/referral hotline. Consumer Action also develops free consumer education modules, training, and multi-lingual materials for its network of more than 8,000 community based organizations. Consumer Action's publications are offered in Chinese, English, Korean, Spanish and Vietnamese.

Consumer Federation of America (CFA) is a nonprofit association of some 300 national, state, and local pro-consumer organizations created in 1968 to represent the consumer interest through research, advocacy, and education.

The National Fair Housing Alliance is a consortium of more than 220 private, non-profit fair housing organizations, state and local civil rights agencies, and individuals from throughout the United States. Headquartered in Washington, D.C., the National Fair Housing Alliance, through comprehensive education, advocacy and enforcement programs, provides equal access to apartments, houses, mortgage loans and insurance policies for all residents of the nation.

The Center for Responsible Lending is a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

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I. OVERVIEW: THE BOARD'S PROPOSAL WILL FOSTER AND INCREASE HELOC ABUSES

"There are two mistakes one can make along the road to truth . . . not going all the way, and not starting."
–Buddha

A. *The Board Has Abdicated Its Responsibility to Deal with Substantive HELOC Abuses*

We commend the Board for undertaking its ambitious review of Regulation Z, and for its use of consumer testing. We also commend the Board for requiring HELOC disclosures to be based on the premise that the entire line of credit is drawn down at closing. These provisions, as well as many of the Board's proposed revisions to Regulation Z in the closed-end dockets hold great promise. However, in general the Board's HELOC proposal falls far short of what is needed. It will lead to greater abuses in the HELOC market, and will undermine the Board's insightful reforms for closed-end mortgage transactions.

In contrast to the vigorous new disclosures proposed for closed-end credit, the proposal for HELOCs in *this* docket is likely to result in a great surge in abusive HELOC lending. The Board fails to recognize both that HELOCs have contributed considerably to the current mortgage disaster, and that if one area of the mortgage market is heavily regulated, predatory activities will migrate to the less regulated sector. Unless the Board tightens its HELOC rules to the same extent as its closed-end rules, predatory lending will simply shift to open-end credit.

The one significant improvement in the HELOC disclosures proposed in this docket is the Board's proposal to require initial HELOC disclosures based on the total amount of the line of credit.[3] Requiring that this assumption be the basis for the disclosures is a good step forward—because in so many cases this is exactly what happens, and because it provides a good measurement to compare HELOCs to closed-end credit. However, unless the Board ensures that the disclosures *and substantive requirements* for HELOCs match those required for closed-end mortgage credit in format, content and timing, HELOCs will undoubtedly become the next corner for predatory lending.

Rather than match the appropriately strengthened disclosure requirements for closed-end credit, the Board proposes a weak rule that will not only leave HELOCs open to abuse but will cause abusive lending to migrate to HELOCs from the closed-end market:

- Instead of including all credit charges in the finance charge for HELOCs, the proposal would exclude all charges from the calculation of the APR—making

[3] Proposed Regulation Z § 226.6(a)(2)(v)(C)(1)(i).

APRs for HELOCs appear to be much lower than those for equivalent closed-end loans.

- Instead of requiring early disclosures before closing on HELOCs—just as required for closed-end credit—the proposal would dispense with any requirement for informing the consumer of the costs and risks of these home secured extensions of credit prior to closing.
- Instead of making the two forms of home secured credit mirror each other—to ease comparison between the two different products—the proposed HELOC disclosures are based on a whole different set of assumptions and requirements.
- Instead of proposing the same substantive restrictions for both HELOCs and closed-end mortgage loans, the Board has proposed a dramatically more lax regime for HELOCs.
- The radical difference between the two regimes—open and closed-end home secured credit—will facilitate, if not actively encourage, the rapid development of predatory lending in the relatively unregulated HELOC market.

The regulatory regime for HELOCs proposed by the Board completely fails every one of the principles Governor Duke articulated recently as essential to "remedy the nation's ailing mortgage finance system." On December 10, 2009, Governor Duke articulated her vision of how to fix the mortgage market. She explicitly said that policymakers need to focus on four key principles as they evaluate new structures to remedy the nation's ailing mortgage finance system. Those principles include *consumer protection and transparency*. In addition, she said any new policy structures must emphasize simplicity.[4]

The HELOC regulations proposed by the Board include virtually no consumer protections, and make determining the real costs of HELOC much more difficult. The proposals made in this docket thus fail Governor Duke's recommended tests.

In later sections of these comments we address the specifics of the Board's proposed HELOC rules in detail. However, our comments on these specifics should not be misunderstood. Even if the Board addresses these specifics exactly as we recommend, the overarching problems created by the bifurcated system of disclosures and substantive regulation would remain. Creating wide discrepancies between open- and closed-end home-secured credit (both in disclosures and substantive provisions) will have severely negative consequences:

1. Consumers evaluating different forms of home secured credit will find it impossible to measure the costs of the different types of credit—between open and closed-end.
2. The inability of even the most sophisticated consumers to evaluate the relative costs of open and closed-end credit will create market sweet spots for higher cost credit: hidden charges and more onerous terms will not be transparent in open-end credit, yet will be more exposed in closed-end credit.

[4] Banking Daily, Mortgages, *Fed's Duke Outlines Vision for Fair, Efficient Market for Home Mortgages*, Dec. 10, 2009.

3. The lack of equivalent disclosures between the two forms of home secured credit will encourage predation in the credit market with the weaker disclosure requirements—HELOCs.
4. Differences between substantive requirements will do much more than exacerbate the problem created with the different kinds of disclosures; the complete lack of standards for one form of credit will facilitate bad lending policies and cause a proliferation of unaffordable HELOC credit—without federal remedies.

B. *The Recognized Practice of Making High Loan-to-Value HELOCs Should Trigger* More *Regulation and Stricter Disclosures, Not Less As Is Proposed*

The Board itself has noted that past market conditions have already made HELOCs an attractive form of credit for a variety of uses which are not directly related to purchasing, maintaining or improving the home used to secure the credit:

> Beginning in the late 1990s, consumers increased their use of HELOCs for expenses such as vehicle purchases, education, and vacation. Many HELOC consumers today, as in the past, use their lines as emergency sources of funds.[5]

In addition, HELOCs have been widely used, especially in the subprime market, as part of 80–20 transactions to purchase or refinance homes. At the same time as HELOC lending has been expanding in these ways, creditors have been willing to secure the homes at higher and higher loan-to-value ratios. "By the mid-2000s, more creditors were willing to lend HELOCs at a combined loan-to-value ratio of 100% or more, and despite home value appreciation, the overall percentage of equity remaining in homes was appreciably lower that than in early years. The Board's survey of Consumer Finances indicates that the average outstanding dollar amount of a HELOC grew from $24,000 in 1998 to $39,000 in 2007."[6]

The willingness to make home loans secured at, or close to, 100% of the value of the home, is a clear illustration that current HELOC lenders already have an appetite for risky home secured lending. It has long been recognized that the credit secured by the value in a home over 80% is generally equivalent to no security.[7] A junior creditor foreclosing on a home with a first mortgage equal to 80% of the value is unlikely to reap any monetary value from a foreclosure.[8] However, even in this situation, the security

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[5] 74 Fed. Reg. 43,429, n.4.

[6] *Id.*

[7] In 1998, the Office of Thrift Supervision stated:

> When the combined LTV exceeds 90 percent, however, the proceeds from the sale of the security property will likely not be sufficient to fully liquidate the home equity loan and any outstanding senior liens. The portion of such loans that exceeds 100% of value is effectively unsecured, so lenders are likely to suffer a complete loss if they make a mistake in assessing a borrower's credit and the borrower subsequently defaults .... High LTV lenders state that they recognize that these loans are more or less unsecured, and it is not likely they will benefit from foreclosure.

Office of Thrift Supervision, Department of the Treasury, Thrift Bulletin TB 72, at 2, Aug. 27, 1998.

[8] *Id.*

interest itself is still very valuable to the creditor because it enables the creditor to use the threat of foreclosure as a debt collection tactic. The threat of forcing a foreclosure for nonpayment is a powerful incentive to encourage a recalcitrant borrower to repay the loan.

In the Credit Practices Rule, the Federal Trade Commission—and later the Federal Reserve Board—found the practice of using the threat of repossession of property which would yield no monetary value to creditor, but would cause considerable loss for the consumer, to be *in terroram*, and thus unfair and illegal.[9] The context was the practice of some lenders of taking non-purchase money security interests in household goods. The repossession and sale of those household goods would yield insignificant monetary value to the lender, but cause havoc to the borrower. The government agencies found this to be an unfair use of security interests because the only real value of such an interest was to terrorize the borrower into repaying the debt. The financially worthless junior lien on a home with 20% or less of equity is exactly the same. Yet the Board makes no mention of these problems, and takes no steps to strengthen any regulations of high loan-to-value HELOCs.

According the Board's own findings, the practice of taking second liens above 80% of the loan-to-value of the home is relatively new—and thus understandably, thinly regulated.[10] At the same, the amount of these second liens is increasing; according to the latest data available, the average outstanding dollar amount for a HELOC is now $39,000.[11]

The increasing utilization of these financially useless—but nevertheless terrorizing—security interests in homes through the HELOC mechanism should be sufficient incentive for the Board to be evaluating the practices surrounding these loans. But there are more basic facts about HELOCs which dictate close scrutiny, and a much elevated level of regulation. Indeed, there is simply no justification for the widening of differences between the disclosures required for HELOCs and those required for closed-end credit which is proposed by the Board in this Docket. Surprisingly, the Board has not even considered extending the substantive protections it is proposing to be applicable to closed-end credit to HELOCs (specifically prohibiting steering, limiting the use of yield spread premiums, and regarding the previously required ability to repay analysis).

In the Closed-End Proposal, the Board asks the question of whether the existing substantive prohibitions applicable to closed-end loans should also be made applicable to HELOCs. Our answer is an emphatic "Yes." We have endeavored in these comments to present the logical basis for equivalency in protections between the two forms of home secured credit. The Board asks for proof that the problems already exist in the HELOC market to substantiate the need for equivalent protections. Our point is that the Board is

[9] 16 C.F.R. § 444.2(a)(4) (FTC action); 12 C.F.R. § 227.13(d) (Federal Reserve Board action).
[10] As the Board notes: "When the Board published the 1989 HELOC Final Rule, it was commonly expected that most HELOC borrowers would, at their maximum credit line limit, retain around 20 percent of their home equity. 75 Fed. Reg. 43,429, n.8
[11] *Id.*

asking the wrong question. Whether the problems currently exist is not relevant to the issue of whether they will grow once the regulatory gap widens. As is evident by the fact that there are many HELOCs which are inappropriately secured by the home, there are already problems that justify further regulation.

C. *The Board's Approach to HELOC Disclosures Is Based on Flawed Assumptions*

Another fundamental problem with the Board's HELOC proposal is that it has based the proposed disclosure regime on two flawed assumptions. First, it assumes that HELOC borrowers actually seek out HELOCs. The idea is that HELOC borrowers make deliberate decisions to use HELOCs because of their flexibility and that borrowers who draw the full amount of the line of credit do so because this is part of their "plan."[12] While some borrowers in the prime market may actually make these choices, it is simply inapposite in the subprime market.

Instead in the subprime HELOC market, HELOCs are provided primarily as 80-20 financing deals. The lender finances 80% of the obligation with a closed-end mortgage and the remaining 20% with a HELOC. The transaction may be a home purchase or a refinance, but in either event the borrower is highly leveraged, with little or no equity cushion. The borrower rarely understands the terms of the deal before closing, or even that there are two separate loans, and is never made aware that one of the loans is a HELOC. The HELOC is a line of credit in name only, as nearly the entire amount available is drawn down at closing. Nothing in this Docket indicates that the Board has recognized these basic facts about the subprime HELOC market.

Typically, in an 80-20 transaction, the homeowner requests a certain amount of credit. The originator does the analysis of: a) the value of the home; b) the necessary amounts to be covered by the extension of credit (to purchase the home or to refinance previous loans); and c) the fees charged by the originator. The originator then provides a standard 80% loan-to-value first mortgage—which is often sold to investors on the secondary market without any mention to the eventual owners of those loans that the borrowers are highly leveraged. To cover part of the purchase price or to pay off other debts or the closing costs of the first mortgage, the originator provides a HELOC, secured by the remaining 20% value in the home.

In situations like these—which the signatories to these comments believe to describe the majority of subprime HELOCs—there is no *seeking* of a HELOC by the borrower. The homeowner generally does not even know until the moment of closing the loan that there will be two separate loans, and two separate loan payments. In the flurry of papers that characterizes even the most legitimate of closings, it is unlikely that anyone would appreciate the significant differences in the disclosure rules between the large first mortgage and the tag-along HELOC that is provided.

The Board's consumer testing displays this same blindness toward 80-20 loans. The consumer testing company only selected consumers who had previously obtained or

[12] 74 Fed. Reg. 43,428, 43,450 (Aug. 26, 2009).

considered HELOCs.[13] It failed to select any consumers who were not already familiar with HELOCs. Yet in the typical 80-20 transaction the creditor provides a HELOC to a consumer who has not sought one and is not at all familiar with them. Given the complexity of HELOCs, it is highly unlikely that a consumer who has not sought one and is not expecting one will understand and absorb the Board's proposed disclosures, even with their improvements in format and clarity. The consumer testing report thus does not provide guidance on the question of how to disclose or regulate HELOCs in the subprime 80-20 context.

This problem is heightened by other selection criteria for the consumer testing. ICF Macro's screening eliminated all consumers who could not give a "thoughtful, articulate answer" to the question why they had decided to take out a line of credit or home equity loan.[14] This biased the study toward more sophisticated consumers. While it appears that perhaps two of the forty participants had obtained HELOCs in piggyback transactions,[15] it is highly unlikely that these participants were representative of the subprime 80-20 borrower who is given a HELOC without even realizing that two loans are in the offing.

These are only some of many reasons why the same type of disclosures, based on the same rules, must be provided at the same times—after application and well before closing—and in the same format for HELOCs and closed-end mortgages. To the extent that the Board expects any real consumer protection to result from full disclosure, the entire disclosure rulebook must be simplified—and all home mortgage credit disclosures should look just alike and be based on the same set of rules. Otherwise, even the most sophisticated consumers cannot be expected to protect themselves by relying on disclosures.

A second fundamental error is that the Board is treating HELOCs as an alternate form of a credit card, not an alternate form of a mortgage. Even though some consumers may use their home equity like a credit card, HELOCs and credit cards are drastically different products. Credit cards are unsecured. The non-payment of a credit card is unlikely to cause the loss of the family home. The non-payment of a loan secured by that home can cause that loss. Moreover, it is likely that when the payments for a HELOC become unmanageable, consumers make every effort to pay off the HELOC by refinancing the first mortgage, so long as there is sufficient equity.

The effect of the Board's flawed assumptions is exacerbated by its inexplicable decision to propose a system in which HELOC creditors can dispense entirely with all early disclosures. As discussed in detail in Section III of these comments, the Board is

[13] ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit Appx. B (July 16, 2009).
[14] ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit Appx. A (July 16, 2009).
[15] ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 16 (July 16, 2009).

giving its blessing to the practice of giving the borrower the first and only disclosures about the terms of the HELOC *at closing*.

Instead of the current disclosure proposals, the Board should go back to the drawing board, and:

- Require that APRs for HELOCs include all upfront fees. Otherwise, HELOC APRs will appear lower than the APRs for comparable closed-end mortgages, giving consumers the *false impression that the HELOC rate is lower*.
- Continue requiring and strengthen the pre-closing HELOC disclosures..

D. *The Board Has the Opportunity Here to Stop the Abuses in the HELOC Marketplace Before They Grow*

The Board's persistence in creating an uneven regulatory and disclosure playing field between HELOCs and closed-end credit, as proposed in the two dockets, will create havoc. Rather than the abuses appearing in the closed-end mortgage arena, the new predation will occur in the HELOC products. Brokers will be able to sell HELOC loans as lower priced when in fact they are not, but the APRs will only make them appear to be. Brokers will be able to steer borrowers to the higher cost loans with impunity, and charge yield spread premiums without regard to double charging. Regardless of the cost of the loan, no HOEPA provisions will apply. There will be no prohibitions against balloon payments, prepayment penalties, default rates, or other manifestly unfair practices—even those long recognized to be unfair in the prime market and outlawed by the Board. *The Board should take this opportunity to avoid these ills before they are created.*

The Board does not even discuss extending the limitations on lender-paid broker compensation to HELOCs. There is no reason to think that HELOCs are exempt from the pernicious influence of broker incentives and steering. Indeed, given the significantly weaker cost disclosures proposed for HELOCs, there is every reason to think that brokers will have a greater ability to extract surplus fees from borrowers. For the reasons given by the Board in its closed-end proposal and described in Section XI of our closed-end comments, and the more detailed comments submitted by the Center for Responsible Lending, the Board should extend the protections against lender-paid broker compensation and steering to HELOCs.

Along with requiring that the disclosures for HELOCs mirror those for closed-end mortgage credit, the Board should also apply equivalent substantive prohibitions that we recommend:

1. Extend the requirements currently applicable only to higher cost closed-end credit loans[16] regarding the determination of the borrower's ability to repay, to *all* mortgage loans secured by a borrower's principal residence.

[16] Regulation Z § 226.35.

2. Require underwriting for all adjustable rate loans which determines the borrower's ability to repay the highest possible payments that may be required under the loan terms (counting both alternative amortization terms and the highest permissible interest rates).

3. Prohibit the initiation of a foreclosure unless the HAMP loan modification analysis and procedure have been completed.

We are aware that in the past, the Board has twice declined to extend its authority to prohibit unfair practices in the mortgage market to HELOCs.[17] Both times the stated reason was that the problems being addressed in the closed-end market had not yet manifested themselves in the HELOC market.[18] However, we have already demonstrated at least one standard practice of HELOC lenders—the practice of securing homes with loans at a high loan-to-value ratio—is quite similar to practices which the Board and the FTC have already found to be unfair and thus illegal. The two case studies[19] below illustrate that the HELOC market is, by no means, immune from abusive practices:

Case Study 1: Ms. Nessia Jones

In 2006, GreenPoint Mortgage Funding made two mortgage loans to Ms. Jones that should never have been made. At the time Ms. Jones, an African-American homeowner, had lived in her home in Decatur, Georgia for 27 years. Ms. Jones has received Social Security widow's benefits since 1988. Her mental and physical health is poor and requires an extensive medication regime. Ms. Jones's adult daughter who lives with her has been disabled since infancy, is profoundly mentally retarded, and suffers from seizures.

Loan Summary

Lender	GreenPoint Mortg. Funding	GreenPoint Mortg. Funding
Loan date	October 31, 2006	October 31, 2006
Principal	$120,700.00	$30,100.00 HELOC
Interest rate	8.625% fixed	13.25% ARM
APR	9.168%	NA
Term 30	years	15 years
Monthly payment	$938.79 P&I only	$327.80 interest only
Escrow	None	None
LTV	80%	100%

Ms. Jones's monthly income at closing was $633 in Social Security. The combined monthly mortgage payments ($1,266.59) were 200% of her monthly income. The loan application stated Ms. Jones was not employed and received Social Security disability

[17] *See* changes in 2002 and 2008 to Regulation Z §§ 226.34, 226.36.
[18] *Id.*
[19] The National Consumer Law Center thanks Karen Brown, of the Atlanta Legal Aid Society in Georgia, and Jennifer Wagner, of Mountain State Justice in West Virginia, for these two case studies.

benefits, but also stated that her income was $3,950 from employment income. The information on the loan application was obviously inconsistent and falsified.[20] The lender's loan files did not include any documentation of her income. GreenPoint apparently made these mortgages based on the value of the home ($150,900 per GreenPoint's appraisal), not her ability to pay.

Coverage and effect of proposed FRB rules
Nothing in the Board's pending HELOC proposal would prevent a lender from originating the same HELOC again.

Case Study 2: Mr. and Mrs. B

In 2005 Beneficial Loan Company heavily solicited Mr. and Mrs. B for a second mortgage they should never have been offered. Mr. and Mrs. B own a $30,000 house in a small town in West Virginia. Mr. B is disabled, receiving Social Security disability, and Mrs. B is a clerk at a local hospital. At that time, their house was approximately $20,000 underwater because their first mortgage lender had used a fraudulent appraisal to justify a $50,000 loan.

Beneficial Loan Company convinced the B's to take out a debt consolidation loan for $40,000, using the home insurance valuation of $90,000 to justify the CLTV ratio. The B's were not told, nor did they understand that Beneficial was giving them a HELOC instead of a closed-end second mortgage. The HELOC had an interest rate of 13.99% and credit insurance payments of .154 cents per every hundred owed on the loan. The HELOC was fully drawn for the full $40,000 credit line at closing and would require a $24,000 balloon payment at the end, even if the B's made the minimum payments of over $500 a month.

Coverage and effect of proposed FRB rules
Because this loan was open-end, rather than closed-end, the lender did not treat it as a HOEPA loan. While the B's would receive improved disclosures under the Board's current HELOC proposal, the Board has not proposed anything substantive that would prevent this from taking place again.

As illustrated by these two case studies, it is important that the Board enact regulations that will prevent foreseeable problems. The failure to do so was, in hindsight, a central factor in the recent recession. Waiting until problems are manifest in the HELOC market is courting disaster, especially where the growing chasm between closed-end and open-end disclosures will likely encourage deceptive practices in the HELOC market.

Moreover, our primary point here is to make the case for *totally equivalent regulation between open- and closed-end credit.* If one side of the market is regulated

[20] In 2006 the average monthly Social Security benefit for disabled workers was $947. The maximum retirement benefit was only $2,053.

much more than the other, predatory behaviors will simply shift to the unregulated side. Thus, to prevent this natural migration by predators to the least regulated side of the market, while the Board considers the substantive proposals we set out for closed-end credit in our comments in Docket No. R-1367, it *must* also consider those same proposals for open-end credit.

E. *Disclosures Are Insufficient to Protect Consumers from the Dangers of Certain Loan Products and Terms*

No amount of disclosure can adequately protect the American public from the failure to underwrite for the basic affordability of loans that characterized most of the subprime market, and much of the prime market during the last decade.

Although the law now recognizes the unequal bargaining power inherent in typical consumer contracts,[21] high-rate and high-risk credit has been presented as a boon to needy borrowers, who otherwise would lack access to needed capital. After all, we are told, lenders seldom place a gun to a borrower's head, so the borrower must have asked for the credit received. The Board's reliance on disclosures—even assuming the disclosures were perfectly clear and transparent—still leaves the market to police itself. The current financial crisis is the best indication that the mortgage market simply does not have the means, the incentive, or the inclination to police itself.

Premising protection of consumers almost entirely on disclosures assumes that the credit market functions; that pricing is or can be made transparent to borrowers; that borrowers do not face duress when making borrowing decisions; and that borrowers are able to exercise sufficient influence over the terms of lending transactions to constrain creditors' behavior.

In fact, due to market segmentation (the splitting of the market into prime, subprime, and predatory), steering, and information asymmetries,[22] credit markets often

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[21] *E.g.*, American Fin. Serv. Ass'n v. Federal Trade Comm'n, 767 F.2d 957 (D.C. Cir. 1985) (consumers' limited ability to shop for and bargain over terms cited as grounds for upholding FTC credit practice rule). *See generally* Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13.2 Stan. L. & Pol'y Rev. 233, 243–251 (2002) (collecting cases).

[22] Cassandra Jones Havard, *Democratizing Credit: Examining the Structural Inequities of Subprime Lending*, 56 Syracuse L. Rev. 233 (2006) (discussing market segmentation and information asymmetries); Elvin K. Wyly, Mona Atia, Holly Foxcroft, Daniel J. Hamme, Kelly Phillips-Watts, *American Home: Predatory Mortgage Capital and Neighbourhood Spaces of Race and Class Exploitation in the United States*, 88 Geografiska Annaler, Series B: Human Geography 105 (2006) (arguing that lenders have targeted vulnerable neighborhoods); Ronald J. Mann, *"Contracting" for Credit*, 104 Mich. L. Rev. 899, 914–915 (2005–2006) (describing how complexity, segmentation, and unilateral modification of terms combine to prevent increased consumer sophistication from reducing profits or increasing market efficiency); Ronald H. Silverman, *Toward Curing Predatory Lending,* 122 Banking L.J. 483, 531–544 (2005) (discussing information asymmetries, rent seeking, lack of competition, and adverse selection in predatory home mortgage lending); Michelle A. Danis & Anthony Pennington-Cross, The Delinquency of Subprime Mortgages 7 (Fed. Res. Bank St. Louis, Working Paper 2005-022A Mar. 2005) (discussing economic theories to explain market segmentation between prime and subprime), *available at* http://research.stlouisfed.org/wp/2005/2005-022.pdf; Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255, 1271–1283 (2002).

do not function. Pricing is often disconnected from actual risk. The credit offered a borrower may have as much or more to do with where the borrower lives than any objective assessment of the borrower's likelihood of repaying that credit. Some high-cost lenders exhibit reverse competition, charging higher pricing when there is more "competition."[23]

Pure reliance on the principle of *caveat emptor* is an inappropriate solution, too, for at its core its message to consumers is: "assume that all business people are out to cheat you until proven otherwise." At least one court has rejected this "trust no one" approach,[24] and it is unlikely that ethical businesses, or our society as a whole, would consciously adopt that as a positive component of our economic system.

For a borrower's contractual "choice" to have any meaning, borrowers must be able to evaluate the risks and benefits of the credit offered. Borrowers must also have meaningful alternatives to the credit presented. Neither of these premises describes the reality for many people.[25] The fiction of informed choice collapses entirely for especially vulnerable consumers—the illiterate, the uneducated, frail older consumers, and those for whom English is a second language. Many borrowers have a misplaced faith that lenders will—indeed are required to—provide the best rates.[26] Worse, abusive sellers and lenders frequently target borrowers who are perceived as vulnerable, including members of racial groups historically excluded from mainstream credit, on the belief that the

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[23] *See, e.g.,* Robert DeYoung & Ronnie J. Phillips, Federal Reserve Bank of Chicago, Strategic Pricing of Payday Loans: Evidence from Colorado, 2000–2005, at 20, 22 (July 14, 2006), *available at* www.chicagofed.org/cedric/2007_res_con_papers/car_48_deyoungphillips_fedcommaffairsconf_715_preliminary.pdf (finding, in preliminary results, higher prices for payday lending higher in markets more thoroughly saturated by payday lenders).

[24] Northwestern Bank v. Roseman, 344 S.E.2d 120 (N.C. Ct. App. 1986), *aff'd*, 354 S.E.2d 238 (N.C. 1987).

[25] *See* Till v. SCS Credit Corp., 541 U.S. 465, 124 S. Ct. 1951, 1962–1964, 158 L. Ed. 2d 787 (2004) (recognizing that the subprime auto finance market is not "perfectly" competitive and that creditors have much more information about the market than do consumers); Richard Lord, American Nightmare: Predatory Lending and the Foreclosure of the American Dream (Common Courage Press 2005); Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 Harv. J. on Legis. 123, 139–149 (2007) (discussing lack of price transparency); Elizabeth Renuart, *An Overview of the Predatory Lending Process*, 15 Housing Pol'y Debate 467 (2004); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255 (2002). *Cf.* Sumit Agarwal, John C. Driscoll, Xavier Gabaix, & David Laibson, The Age of Reason: Financial Decisions Over the Lifecycle 37 (Feb. 11, 2008), *available at* http://ssrn.com/abstract=973790 (finding that older and younger borrowers pay more for credit than midlife borrowers across a range of credit products, perhaps because older and younger borrowers do not understand "shrouded attributes," such as the relationship between higher LTVs and higher APRs).

[26] Mortgage Foreclosure Filings in Pennsylvania: A Study by The Reinvestment Fund for the Pennsylvania Department of Banking 74 (Mar. 2005), *available at* www.trfund.com/policy/pa_foreclosures.htm, *citing* Fannie Mae's 2002 National Housing Survey. *Cf.* Martinez v. Freedom Mortgage Team, Inc., 527 F. Supp. 2d 827 (N.D. Ill. 2007) (Hispanic borrower's belief that broker would not arrange and lender would not originate loan he could not afford was reasonable); 74 Fed. Reg. 44,522, 44,542 (July 30, 2008) ("Borrowers could reasonably infer from a lender's approval of their applications that the lender had appropriately determined that they would be ale to repay their loans."); 74 Fed. Reg. at 44,564–44,565 (discussing consumer testing showing that many consumers believe that brokers are "obliged to find them the lowest interest rates and best terms available").

borrowers are, in some sense, still a captive market.[27] And borrowers who are a captive market are charged more.[28]

Clearly, borrowers do not have equal understanding or experience with credit as creditors do. And borrowers are at a further disadvantage when they confront the written materials creditors offer up. Even with greatly improved disclosures and round after round of consumer testing, the Board's own consumer testing report shows that many consumers—even the relatively sophisticated, articulate experienced borrowers who were selected for testing—simply cannot understand critical aspects of mortgage disclosures.[29] The complexity of the products now exceeds what most consumers, even educated consumers, are capable of comprehending.[30]

Moreover, the entire premise of basing consumer protection on disclosures assumes that consumers will actually shop and compare different loan products. The Board's testing showed that shopping for home mortgages is largely a myth. The closed-end consumer testing showed that only about half of research participants consulted more than even one lender or broker when looking for a mortgage loan[31] and only two participants in the HELOC testing did any shopping.[32] It is highly unlikely that the pattern is different for HELOCs.

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[27] *See, e.g.*, Carlisle v. Whirlpool Fin. Nat'l Bank, Civil Action No. CV 97-068, Clearinghouse No. 52,516 (Circuit Court, Hale County Ala. Aug. 25, 1999)(finding defendants behavior "alarming" and "reprehensible," based on sales practices of targeting and take advantage of the poor, under-educated, older, and African-American citizens); McGlawn v. Pa. Human Relations Comm'n, 891 A.2d 757 (Pa. Commw. Ct. 2006) (finding that brokerage firm targeted African Americans through advertising in sources "oriented toward African American audiences"). *See generally* National Consumer Law Center, Credit Discrimination Ch. 8 (5th ed. 2009).

[28] Robert DeYoung & Ronnie J. Phillips, Federal Reserve Bank of Chicago, Strategic Pricing of Payday Loans: Evidence from Colorado, 2000–2005, at 20, 22 (July 14, 2006), *available at* www.chicagofed.org/cedric/2007_res_con_papers/car_48_deyoungphillips_fedcommaffairsconf_715_preliminary.pdf (finding, in preliminary results, that repeat borrowers, i.e., borrowers who were "flipped" into a new payday loan, were charged more than one-time borrowers).

[29] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages (July 1, 2009), *available at* www.federalreserve.gov/boarddocs/meetings/2009/20090723/Full%20Macro%20CE%20Report.pdf.

[30] *See* James M. Lacko & Janis K. Pappalardo, Fed. Trade Comm'n, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms, at ES-11 (2007), *available at* www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (prime borrowers have difficulty answering questions about their loans; difficulty increases as loan becomes more complex); Comments of the Ctr. for Responsible Lending on Advance Notice of Proposed Rule-Making, Regulation Z, Subpart B: Open-End Credit 22 (Mar. 28, 2005), *available at* www.responsiblelending.org/pdfs/Comment_FRB032805.pdf ("[C]ollege-educated consumers consistently underestimate[] how long it would take to pay off credit card balances."); William C. Apgar, Allegra Calder, & Gary Fauth, Jt. Ctr. for Housing Studies, Harvard University, Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations 40, 50–51 (Mar. 2004), *available at* www.jchs.harvard.edu/publications/communitydevelopment/ccc04-1.pdf (discussing inability of even sophisticated consumers to understand mortgage products).

[31] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-end Mortgages 5 (July 1, 2009).

[32] ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 7, 16 (July 16, 2009).

Legal scholars and behavioral economists have applied well-established insights of psychology to demonstrate that many, if not most, consumers make systematic errors of judgment in evaluating credit.[33] Most consumers, even educated consumers, focus on the payment to estimate the cost of a loan.[34] This focus on the payment works fine as a short-cut if the loans being compared are fixed-rate loans with the same time to repay. But it gravely misleads borrowers comparing loans of different lengths or with adjustable-rate periods. Negative amortization, interest-only payments, and hybrid ARMs that include built-in step increases along with adjustable rates exacerbate these problems.

When one adds in the difficulty of comparing complex, closed-end credit terms which very based on different disclosure premises with open-end contracts, it is highly unlikely that any consumer would be able to reasonably calculate the comparable costs and risks.

An unregulated free market system rewards creditors who understand and take advantage of systematic biases to hide the real cost of credit.[35] Little wonder then that too many creditors understate or obscure the real cost of credit (sometimes as permitted by law, other times not).[36]

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[33] *E.g.,* Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 Yale J. on Reg. 181 (2008); Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts,* 92 Minn. L. Rev. 749, 761–765 (2008); Oren Bar-Gill, *Bundling and Consumer Misperception*, 73 U. Chi. L. Rev. 33, 45 (2006); Susan Block-Lieb, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided "Reform" of Bankruptcy Law,* 84 Tex. L. Rev. 1481 (2006); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price,* 65 Md. L. Rev. 707 (2006); Matthew A. Edwards, *Empirical and Behavioral Critiques of Mandatory Disclosure: Socio-Economics and the Quest for Truth in Lending*, 14 Cornell J.L. & Pub. Pol'y 199, 221–223 (2005); Jason J. Kilborn, *Behavioral Economics, Overindebtedness & Comparative Consumer Bankruptcy: Searching for Causes and Evaluating Solutions,* 22 Emory Bankr. Dev. J. 13, 18–19 (2005); Patricia A. McCoy, *Elder Law: A Behavioral Analysis of Predatory Lending*, 38 Akron L. Rev. 725, 734 (2005) (detailing the difficulties faced by shoppers for subprime mortgage loans); Oren Bar-Gill, *Seduction by Plastic*, 98 Nw. U. L. Rev. 1373 (2004); Jeff Sovern, *Toward a Theory of Warranties in Sales of New Homes: Housing the Implied Warranty Advocates, Law and Economics Mavens, and Consumer Psychologists Under One Roof*, 1993 Wis. L. Rev. 13 (1993); Ren S. Essene & William Apgar, Joint Ctr. for Housing Studies, Harvard Univ., Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans (2007).

[34] *See, e.g.,* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price,* 65 Md. L. Rev. 707 (2006); Ren S. Essene & William Apgar, Joint Ctr. for Housing Studies, Harvard Univ., Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans (2007).

[35] *See* Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 Minn. L. Rev. 749, 789 (2008) (arguing that consumer misperceptions cause market distortions in pricing and other attributes of credit).

[36] *See, e.g.*, Miller v. Americor Lending Group, Inc., 2007 WL 107664 (W.D. Mich. Jan. 9, 2007) (broker offers to arrange fixed-rate, non-negatively amortizing, pick-a-payment 2% interest rate loan and provides initial Truth in Lending disclosures, although knew no such loan existed); Fed. Trade Comm'n v. Chase Fin. Funding, Inc., No. SACV04-549, Complaint, at 4 (C.D. Cal. May 12, 2004), *available at* www.ftc.gov/os/caselist/0223287/040602comp0223287.pdf (adjustable-rate mortgage with initial minimum payment, based on interest at 3.5% amortized over 30 years, which results in negative amortization, since actual interest rate is much higher, advertised as "3.5% fixed payment 30 year loan"); Nationscapital Mortgage Corp. v. State Dep't of Fin. Inst., 137 P.3d 78, 83–84 (Wash. Ct. App. 2006) (broker apparently had pattern of representing on Truth in Lending disclosures that borrower not responsible for broker fee); Gov't Accountability Office, GAO No. 06-1021, Alternative Mortgage Products: Impact on Defaults

Disclosure is not an adequate counterweight to creditor overreaching.[37] In a country in which nearly 40% of the population is estimated to be functionally illiterate,[38] the concept of disclosure loses meaning. Nor does disclosure prevent overshadowing by salespeople who are paid on commission to sell loans.[39]

The Board's mandate to identify and prohibit unfair and deceptive practices is not discretionary:

> **The Board, by regulation or order, <u>shall</u> prohibit acts or practices in connection with . . . mortgage loans that the Board finds to be unfair [or] deceptive.[40]**

The Board has failed to follow Congress' explicit instructions to identify and make illegal unfair and deceptive practices in the HELOC industry. This mandate is not couched as discretionary—the statute does *not* say "the Board *may* prohibit." Congress deliberately and specifically gave to the Federal Reserve Board the *order* to prohibit unfair and deceptive acts in the mortgage industry. The Board must prohibit unfair acts in *both* the closed and open-end mortgage market.

Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved 22 (2006), *available at* www.gao.gov/new.items/d061021.pdf (describing advertisement for payment option ARM that promised 45% reduction in monthly mortgage payments and interest rate of 1.25%; interest rate of 1.25% only applied for first month, and this fact disclosed in "much smaller print" on second page); John R. Wilke, *Hidden Fees in Most Mortgages Bring Scrutiny to Fannie, Freddie*, Wall St. J., Jan. 14, 2005, at A1 (reporting on guarantee fees paid by lenders to Fannie Mae and Freddie Mac that are packaged in the interest rate and undisclosed to borrowers; averaging two-tenths of a percent of the loan amount per month).

[37] *See* Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 Akron L. Rev. 725 (2005) (discussing the cognitive barriers to decision making in the predatory lending context); Ronald H. Silverman, *Toward Curing Predatory Lending,* 122 Banking L.J. 483, 546 (2005) (borrowers, due to a variety of psychological effects, tend to underestimate the risk of foreclosure); A. Mechele Dickerson, *Bankruptcy and Mortgage Lending: The Homeowner Dilemma*, 38 J. Marshall L. Rev 19, 42–47 (2004) (discussing limitation of financial literacy and disclosures due to cognitive biases).

[38] U.S. Dep't of Educ., National Ctr. for Educ. Statistics, Adult Literacy in America (Sept. 1993) (available from the U.S. Gov't Printing Office, GPO stock number 065-000-00588-3), *discussed in*, *e.g.*, Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13.2 Stan. L. & Pol'y Rev. 233, 235–242 (2002); Mary Jordan, *Literacy of 90 Million Is Deficient*, Washington Post, Sept. 9, 1993, at A1). *Cf.* Mark Kutner, Elizabeth Greenberg, Ying Jin, Bridget Boyle, Yung-Chen Hsu, Eric Dunleavy & Sheida White, Literacy in Everyday Life: Results from the 2003 National Assessment of Adult Literacy 13 (2007), *available at* http://nces.ed.gov/Pubs2007/2007480.pdf (22% of the U.S. population has less than basic proficiency in quantitative literacy).

[39] *See, e.g.*, *In re* First Alliance Mortgage Co., 298 B.R. 652 (C.D. Cal. 2003); Diana B. Henriques and Lowell Bergman, *Mortgaged Lives: A Special Report; Profiting from Fine Print with Wall Street's Help*, N.Y. Times, Mar. 15, 2000, at A1 (reporting on allegations against First Alliance Mortgage about its sales tactics).

[40] 15 U.S.C. § 1639(l)(2) (emphasis added).

II. THE PROPOSED COST OF CREDIT DISCLOSURES FOR HELOCS ARE INADEQUATE

TILA is, at its core, a statute about the disclosure of price information. Key to TILA's cost of credit disclosures are the finance charges and the APR. When properly calculated, the APR provides a unit measure for comparing loans across different categories of credit, with different terms, fees, and rates. Good disclosure of the APR may drive down the cost of credit;[41] poor disclosure of the APR has been cited as one cause for the collapse of the subprime mortgage market.[42]

A. *The Cost of Credit Disclosures for HELOCs Should Permit Comparison with Closed-End Home-Secured Loans*

The Board's proposed cost of credit disclosures for HELOCs are based on a fundamental error: that HELOCs should be and are compared to open-end unsecured loans by consumers. This is a seriously flawed premise. Instead, consumers and creditors both use HELOCs interchangeably with other products secured by the home: closed-end home equity loans. By failing to provide for comparison to their closest competitor, the Board endorses and facilitates misleading pricing for HELOCs.

The HELOC disclosures proposed even fail to provide for comprehensive, understandable price disclosure from one HELOC to another. Unfortunately the proposal ignores the limitations of virtually all consumers in pricing credit and requires homeowners to perform the impossible task of aggregating fees and interest to determine a comparable cost of credit. Worse, the Board's proposed disclosures actually invite creditor circumvention of accurate disclosure by permitting telephone sales and limiting required disclosures to a defined, exclusive list of fees.

The Board's proposed parallel—HELOCs to open-end unsecured—is based on the type of credit extended rather than the purpose for which the credit is being sought and given. This narrow, technical perspective ignores the economic realities of consumer marketplace, encourages pricing distortion, and fails homeowners who look to the Board to provide simplified, usable disclosure.

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[41] *See, e.g.,* S. Rep. No. 96-368, at 16 (1979), *as reprinted in* 1980 U.S.C.C.A.N. 236, 252 (crediting TILA with a reduction in high cost credit from 1969 to 1979); Victor Stango & Jonathan Zinman, How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets 3–4 (Sept. 5, 2006) (unpublished manuscript, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928956) (stating that in markets where TILA disclosures are made reliably, consumers who most underestimate APRs given a payment stream do not overpay on credit; in markets where TILA disclosures are not made reliably, same consumers pay 200–400 basis points more for interest compared to consumers who underestimate APRs to a lesser degree).

[42] Bar-Gill, *The Law, Economics, and Psychology of Subprime Mortgage Contracts*, 94 Cornell L. Rev. 1073 (2009) (arguing that an improved APR could aid consumer-decisionmaking and improve competition and pricing in the subprime mortgage market).

Since the primary purpose of TILA is to promote economic efficiency through informed consumer shopping,[43] the cost of credit disclosures for HELOC should provide for comparison with their closest competitors, closed-end home-secured credit.

1. The Security at Stake in a HELOC—a Home—Makes HELOCs Fundamentally Different from Open-End Unsecured Credit

The consequences for a borrower who defaults on a credit card diverge sharply from those for a borrower who defaults on a HELOC. Borrowers put their homes at risk in a HELOC. In some cases, that risk is more or less attenuated, depending on the presence or absence of a senior lien and the equity in the home, but it is always a more than theoretical possibility that a borrower in defaulting on a HELOC could lose her home. A default on a credit card, by comparison, may generally be discharged in a bankruptcy and certainly does not put the home in immediate jeopardy. For borrowers, this is a fundamental difference. The stakes are high for a borrower when taking out a HELOC. No borrower should take out a HELOC without a full understanding of the risks and benefits of doing so—and a comparison of the relative costs.

2. Homeowners Do Not Generally Distinguish Between HELOCs and Home-Secured Closed-End Loans

As the Board's testing shows, many borrowers do not know whether or not they have a HELOC or a closed-end home-secured loan.[44] Borrowers who do know often report that their lender required that the loan be made in the form of a HELOC, at least in the case of junior purchase money mortgages.[45] Even relatively sophisticated borrowers, such as those in the Board's testing regime,[46] include borrowers who mistakenly believe they have a closed-end loan[47] or cannot tell which type of mortgage they have, even after the distinction is explained to them.[48] No borrowers, however, expressed uncertainty as to whether there was a security interest in their home: for homeowners, the crucial information is that they have a loan on their home. The distinctions between open-end and closed-end credit are not distinctions consumers make in their understanding of home-secured credit.

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[43] Matthew A. Edwards, *Empirical and Behavioral Critiques of Mandatory Disclosure: Socioeconomics and the Quest for Truth in Lending*, 14 Cornell J.L. & Pub. Pol'y 199, 226 (2005).

[44] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 7, 16, 31 (July 16, 2009).

[45] *See, e.g.,* ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 16 (July 16, 2009).

[46] Homeowners were only eligible to participate if they could give a "thoughtful, articulate answer" to the question of why they decided to "take out a line of credit/ home equity loan." ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit Appendix A, at 2 (July 16, 2009). In our collective experience representing thousands of borrowers, few of our clients could have given "thoughtful, articulate" answers to that question.

[47] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 16 (July 16, 2009).

[48] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 7 (July 16, 2009).

B. *The HELOC Cost of Credit Disclosures Should Provide a Unitary Cost of Credit Measurement*

Under the Board's proposal, homeowners who want to comparison shop between closed-end and open-end home secured credit will be provided no assistance. The key price disclosure for closed-end credit, the all-in APR, is nowhere disclosed for open-end credit. Except for the payment example based on the full line of credit,[49] the Board has not provided any metric that would permit comparison shopping between closed-end and open-end home-secured credit.

TILA was enacted in the belief that accurate disclosures would promote economic stability through informed shopping by consumers.[50] Recent history has made all too clear the disastrous consequences that lack of adequate and even disclosure of the cost of credit can have.[51]

Credit pricing is complicated—far beyond what most consumers can comfortably manage on their own.[52] The interplay of one-time fees, interest, and repayment schedules eludes most borrowers. Determining the cost of a HELOC is more difficult than a closed-end mortgage loan—since the repayment schedule and amount of credit may not be known at account opening—and more important than for open-end unsecured credit, since the consumer's home is at stake. Yet the Board has done less testing of cost of credit disclosures for HELOCs than for either open-end unsecured credit or closed-end home-secured credit.

The testing the Board has done, however, clearly reveals the conundrum sophisticated and informed homeowners investigating a HELOC face: How to weight the fees and the interest? In the Board's testing, only two participants reported shopping for a HELOC.[53] One decided not to get a HELOC because the fees were too high;[54] another chose the HELOC with the lowest interest rate.[55] Which homeowner made the correct decision? Without more information about the terms of the offered HELOCs and how the homeowner proposed to (and was permitted to) draw the loan, it is impossible to say. Nonetheless, the Board's testing sheds no further light, not on how the homeowners chose fees or interest to focus on, nor whether that choice was a welfare-maximizing one for the consumer, nor, most importantly, on what information would be helpful in steering those

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[49] It is inappropriate to encourage consumers to rely on the monthly payment as the sole metric for comparing different loans.

[50] 15 U.S.C. § 1601(a).

[51] *See, e.g.,* Oren Bar-Gill, *The Law, Economics, and Psychology of Subprime Mortgage Contracts*, 94 Cornell L. Rev. 1073 (2009) (arguing that the subprime mortgage debacle was caused in part by the failure to provide adequate price disclosures).

[52] *See generally* Elizabeth Renuart & Diane E. Thompson, *The Truth, The Whole Truth, and Nothing But The Truth: Fulfilling The Promise of Truth In Lending*, 25 Yale. J. Reg. 181 (2008).

[53] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 7, 16 (July 16, 2009).

[54] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 7 (July 16, 2009).

[55] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 16 (July 16, 2009).

borrowers to make the best financial choices and encourage the majority who did not shop, to shop.

To fulfill its Congressional mandate of promoting economic stability through the informed use of credit, the Board must reconsider its approach to providing meaningful disclosure that clearly explains the cost of credit in HELOCs. This disclosure should not require borrowers to do advanced math or estimate probabilities. The disclosures must be simple and straightforward in application. Consumers need a unitary measure of the cost of credit.

1. Early and Account Opening Disclosures Should Be Made More Transaction Specific When HELOCs Are Nearly Fully-Drawn at Closing

Despite overwhelming evidence that consumers want and need transaction specific disclosures—so much so that they prefer to wait until after application and payment of a fee to receive the disclosures rather than receiving generic disclosures pre-application[56]—the Board opines that it believes it is not "practicable" to require lenders to provide fully-transaction specific disclosures.[57] Instead, the Board offers early and account-opening disclosures that provide *some* information, but not sufficiently specific information that a homeowner could actually ascertain the actual cost of this loan.

The Board has already addressed the practicality issue by establishing an assumption upon which the disclosures should be based – that the full credit line will be drawn down at closing.[58] There is no reason that information which are the functional equivalent of a closed-end mortgage disclosures could not be provided. Lenders could easily provide detailed information as to the repayment schedule and an inclusive APR, rather than an interest-only APR, which understates the cost of credit. In this era of computerization, requiring creditors to provide transaction-specific information imposes at most a negligible burden on creditors. There is no reason that fully transaction-specific disclosures should not be required, with an all-inclusive APR and an actual repayment schedule.

Creditors have in the past refused to give loan specific disclosures to consumers seeking HELOCs specifically to deny them the opportunity to shop.[59] The failure to provide transaction specific disclosures that are comparable to the closed-end disclosures may lead consumers to think that the HELOC—with its lower APR—is cheaper than a closed-end home equity loan. The result will surely be overpricing of HELOCs and HELOC-borrowing by some homeowners who would be better off with a closed-end

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[56] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit, at iii, 24 (July 16, 2009).
[57] 74 Fed. Reg. 43,428, 43,451 (Aug. 26, 2009).
[58] Proposed Regulation Z § 226.5b(c)(iii)(1).
[59] *See* Nat'l Consumer L. Ctr., Comments of the Nat'l Consumer L. Ctr., Ctr. for Responsible Lending, Conn. Fair Hous'g Ctr., Consumer Action, Nat'l Ass'n of Consumer Advocates, & Nat'l Comm. Reinvestment Coalition to the Board of Governors of the Federal Reserve System [Docket No. R-1340] Regarding Proposed Regulations under the Mortgage Disclosure Improvement Act (Feb. 9, 2009), *available at* www.consumerlaw.org.

loan. There is no reason to allow creditors to conceal the actual price of the loan when a HELOC is the functional equivalent of a closed-end loan.

2. The Board Should Require Disclosure of the Effective APR

The Board now proposes to do away with the disclosure of the effective APR for HELOCs, as it has done for open-end unsecured credit. The Board's authority to do either is questionable, since the effective APR is mandated in the statute.[60] The Board may, under 15 U.S.C. § 1604(f), exempt transactions from these disclosure requirements, but only if there is no "meaningful benefit to consumers in the form of useful information." Without any testing on—or alternative proposal for—a meaningful disclosure of the cost of credit for HELOCs, the Board completely lacks authority to exempt HELOCs from the disclosure of the effective APR.

The Board's alternative proposal—of "interest and fee totals for the cycle and year to date"[61]—is untested and grossly inadequate. Interest and fee totals do not permit consumers to determine whether a larger loan, with more upfront costs, would nonetheless be cheaper, nor whether the benefits of a lower monthly payment produced by an extended amortization are outweighed by the increased interest costs. Interest and fee totals only tell homeowners what they have paid out of pocket; they provide no comparative cost disclosure. They are not the effective APR—which is exactly the information the consumer needs.

The Board bases its belief that the effective APR and that an interest and fees total is unimportant to consumers on testing done on open-end unsecured credit. But the comparison for consumers between open-end unsecured credit and closed-end secured credit is much less salient than that between HELOCs and closed-end mortgages. Moreover, in focusing on existing consumer understanding of the effective APR, the Board misses the point. The point of TILA is to provide consumers with price disclosures that are comparative. A raw dollar total is not comparative.

It is true that the current methodology for determining an effective APR may reflect the idiosyncrasies of that billing cycle. [62] The Board has at its disposal sophisticated economic minds, superior computer modelers, and state-of-the art consumer testing. It may well be that, as with duration in the closed-end mortgage context, the idiosyncrasies of one billing cycle to the next do not influence consumer behavior and decision-making as much as the anecdotal evidence suggests. Or it may be that there is a better way to calculate or disclose the effective APR—by averaging over more billing cycles or providing a graphic that compares that month's effective APR to previous months and to that of other consumers using similar products or the prime rate. Rather than resolving the pressing problem of providing effective price disclosure for a segment of the market subject to increasing abuse, the Board has abandoned the attempt.

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[60] 15 U.S.C. § 1637(b)(6).
[61] 74 Fed. Reg. 43,428, 43,509 (Aug. 26, 2009).
[62] 74 Fed. Reg. 43,428, 43,509 (Aug. 26, 2009).

The Board's disclosure of an interest-only APR on monthly billing statements compounds the problem by suggesting to consumers an incorrect comparison between the all-in APR for closed-end mortgages and the interest-only APR for HELOCs. Such a distorted disclosure is likely to encourage consumers to choose HELOCs even when they are more expensive than available closed-end credit and will only lead to increased preference by creditors for HELOCs with their pricing advantage.

3. The Finance Charge Definition for HELOCs Should Be All-In, As the Board Is Proposing for Closed-End Credit

As outlined by the Board, the all-in approach would return the basic statutory definition of the finance charge to a place of primacy and limit exclusions from the finance charge to "late fees and similar default or delinquency charges, seller's points, and premiums for property and liability insurance."[63] We discuss in detail in our comments submitted to Board on the proposed closed-end rule why this is exactly the approach the Board should take. An all-in finance charge restores vitality to TILA's disclosure regime and reduces opportunities for creditor gamesmanship. Applying the all-in approach to HELOCs is necessary to avoid creating a disjuncture between closed-end mortgages and HELOCs.

If the proposed "charges imposed" category were adopted for HELOCs while the "all in" approach were applied to closed-end mortgages, consumers would be rendered all but helpless when it came to comparing the cost between different types of transactions because they would not be given numbers measured in equal units. They could know for sure only that the total cost given for a HELOC (through the "charges imposed" category) would not encompass the same information as the total cost given for a closed-end mortgage (through the "all in" finance charge). This clarity would provide cold comfort, as it does not assist with actual decision-making.

If the Board adopts the "all in" approach for closed-end mortgages but not HELOCs, the benefits to consumers, creditors, and society as a whole from the establishment of a stronger disclosure regime and more level playing field for honest competition will be undermined. Unscrupulous creditors may well accelerate their migration from the closed-end to the HELOC market. In order to promote stability in the overall residential credit market, the Board needs to move away from thinking about the *type* of credit product offered (closed or open end) and focus on to *what* the credit is usually tied: a consumer's home. If the Board does not treat this entire market the same way, consumers will be vulnerable to entering into HELOC deals that cause them to lose their homes, as is happening with the current foreclosure crisis. And the country will find itself facing yet another economic crisis due to a home credit market that remained rotten.

[63] 74 Fed. Reg. 43,428, 43,244 (Aug. 26, 2009).

4. The Board Should Do Testing to Determine How to Permit Borrowers to Compare the Pricing on Closed-End and Open-End Unsecured Mortgages

The Board is proposing to eliminate the one tool that currently can help borrowers compare the cost of HELOCs and closed-end mortgage loans, the effective APR, without proposing a substitute. Instead, the Board proposes a generic document, "Key Questions to Ask About Home Equity Lines of Credit" that briefly outlines some of the trade-offs between open- and closed-end home-secured credit.

The Board's generic document on HELOCs may indeed encourage some homeowners to explore closed-end home-secured credit as an alternative to open-end. But even if they do so, they will not be able to tell which loan is cheaper. The all-in APR of closed-end credit is so very different in critical aspects from the interest-only APR disclosed for HELOCs. Nor is a one-to-one comparison of fees sufficient to determine the overall cost.

For closed-end credit, the APR represents that interplay of fees and rate. The APR given on the proposed early and account opening disclosures for HELOCs, however, is nothing more than the interest rate. The HELOC APR therefore is not comparable to the all-in APR used for closed-in credit. It will in fact understate the cost of credit compared to a closed-end loan. The effective APR currently provided for is comparable, but that number is not available until after closing. Providing a list of fees and some details about the repayment schedule, as the Board proposes, does not allow homeowners to compare the likely costs of the two different loans.[64]

As explained above, and verified by the Board's testing, most consumers treat HELOCs and closed-end mortgages interchangeably. Few, if any, understand the differences between the two forms of credit. And those few that do understand and attempt to shop have no meaningful guideposts.

The Board's use of consumer testing has helped the Board design improved disclosures. As discussed elsewhere in these comments, the proposed disclosures for HELOCs, while far from perfect, nonetheless represent a significant step forward from the vague and untimely disclosures provided currently. However more consumer testing is necessary to further improve the disclosures for HELOCS. For this testing to have the most impact, the right questions must be asked.

Comparing pricing on open-end and closed-end credit is tricky. That is more reason for the Board to investigate how to do it. The Board's testing to date on HELOCs provides little information on how consumers shop for HELOCs, when they do shop, and no guidance on how they could be assisted in choosing the cheapest loan.

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[64] *See, e.g.,* ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 47 (2009) (most testing participants misled by lower monthly payment and interest rate in choosing as cheaper loan with greater fees). *See generally* Elizabeth Renuart & Diane E. Thompson, *The Truth, The Whole Truth, and Nothing But The Truth: Fulfilling The Promise of Truth In Lending*, 25 Yale. J. Reg. 181 (2008).

The Board should consider developing a single metric, perhaps with a graphic similar to that proposed for the APR in closed-end home-secured credit to, at a minimum, allow consumers to situate their loan in the low- versus high-end of the price spectrum. This metric must, like the APR in closed-end credit, reflect the combined impact of the repayment schedule, the fees, and the rate. Otherwise, consumers will continue to be at the mercy of creditors who can shift their pricing among these components so as to hide the effective cost of credit from homeowners.

C. *The HELOC Cost of Credit Disclosures Must Be Revised So As Not to Invite Creditor Subversion*

The Board's current rules for HELOC disclosures invite creditor subversion of the requirements. Disclosures based on an exclusive list are destined for obsolescence and irrelevance. Nor, given the abuses in credit-insurance on home-secured loans, is there any reason to extend the telephone purchase rule to HELOCs. The Board must close these loopholes in its final rule if it is serious about ensuring that homeowners receive meaningful disclosure of the cost of credit.

1. Credit Insurance Sales Must Be Properly Disclosed and Included in the Finance Charge

As discussed in the Board's closed-end proposal and our comments to the Board's closed-end proposal, creditors have often used the sale of credit insurance to improperly pack fees in home-secured transactions. The requirement of voluntariness is honored in the breach more often than in practice. We welcome the Board's move to deem insurance sold without verification of the consumer's ability to benefit under age and employment restrictions to be included in the finance charge, with a few caveats, discussed in our closed-end comments, Section IV.C.

a. *Credit Insurance Sold After Account Opening Should Automatically Be Included in the Finance Charge*

The Board is correct in proposing to require consent and disclosure in order to exclude credit insurance purchased after account opening from the finance charge in HELOCs as with other open-end plans. This is one small area where HELOCs are functionally closer to open-end unsecured credit than to closed-end mortgages. As the Board explains, the nature of a HELOC is such that creditors commonly continue to sell products to consumers throughout the duration of the plan.[65] It follows that creditors should be required to adhere to the same requirements for exclusion of these premiums or fees from the finance charge *no matter when* the purchase occurs. Thus Proposed Official Staff Commentary § 226.4(b)(7), (b)(8)(2), and (b)(10)-2 should be implemented.

[65] *See* 74 Fed. Reg. 43,438–43,439.

b. *Sale of Credit Insurance in HELOCs by Telephone Should Require Written Disclosures*

The Board proposes that the telephone purchase rule should apply to HELOCs as well as to general open-end unsecured credit. The telephone purchase rule allows creditors to sell credit insurance to homeowners without any disclosure of the cost or utility of the insurance, until after the sale is completed. The Board reasons that billing error provisions protect from any harm, and that consumers benefit from the convenience of telephone shopping.

As the Board recognizes in its closed-end proposal, creditors generally solicit borrowers for credit insurance. It is therefore the creditors, not the borrowers, who derive the most benefit from the convenience of telephone shopping. Moreover, borrowers who purchase credit insurance may do so in the mistaken belief that the insurance provides them some benefit: as the Board's closed-end testing revealed, many borrowers thought, upon hearing about credit insurance, that it was an important product, but few wished to purchase it upon learning that it might not provide them any benefit.[66] This suggests that the sale of credit insurance may be one area where prior disclosures as to the nature of the product are particularly important. Finally, as anyone who has ever disputed a charge with a creditor knows, the process of reversing a charge or stopping a recurring transaction is often complex, time consuming and quite often unsuccessful. It requires initiative and persistence. Homeowners should not run the risk of being sold a product they do not understand or want without written disclosure, solely for the creditor's convenience.

With home-secured credit, the temptation for creditors to layer on the surplus fees is greater. The possibility of recovering fees—either through the collateral or through threats to the homeowner to seize the home—is greater for home-secured credit than for unsecured credit. The corresponding risk to the homeowner is greater, compounded by the possibility of actually losing the home. Creditors' desire to peddle products of dubious value can be accommodated through the prior provision of written disclosure and, as with closed-end credit, at the in-person closing. There is no greater need for the creditor to sell credit insurance to a homeowner without prior written disclosure in open-end credit than there is in closed-end credit.

In deciding on the application of the telephone purchase rule to HELOCs, the Board should review its rationale for not extending the telephone-purchase rule to closed-end home-secured credit: the value of the collateral at stake, the risk to the homeowner, and the availability of a closing at which to make any necessary sale or disclosures. The only difference between the two forms of credit is the availability of the billing error resolution process—and given the difficulties in using this remedy, this difference weighs lightly in the scales. Creditors have not in the past been inhibited from selling credit insurance to homeowners with HELOCs, nor have we ever had a homeowner complain that they were unable to purchase credit insurance over the telephone without prior

[66] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 47, 72 (2009).

written disclosure. The Board's proposal is a solution in search of a problem, with the very real probability that this "solution" will create a problem worse than the one it seeks to solve.

2. The Disclosure of Fees at Account Opening and on the Periodic Statements Should Be Clarified and Made Inclusive

The Board's proposed disclosures of fees imposed during the life of the plan are inadequate. Under the Board's proposal, creditors would be permitted to add additional fees to plans without any disclosure of those fees to consumers, until after the fees were paid.

a. *The List of Other Fees Disclosed Should Not Be Exclusive*

The Board proposes that the list of fees disclosed under Regulation Z § 226.6(a)(2) at account opening and under Regulation Z § 226.7(a)(6) on the periodic statements would be exclusive. The result would be that any other fees imposed during the term of the plan would not be disclosed to homeowners at account opening. The Board chose this route because it "believes the fees listed . . . . to be the most important fees, at least in the current marketplace."[67] The problem, of course, is that the marketplace is not static. As the Board notes, this rule allows creditors to develop "new services (and associated fees)" without disclosure or litigation risk.[68] In other words, creditors are authorized to create new categories of fees in order to evade disclosure.

The Board does suggest that if the undisclosed fees fit in the somewhat broader category set out in proposed Regulation Z § 226.6(a)(3) the creditor would "presumably disclose" the fees prior to the homeowner's obligation to pay the fee.[69] Creditors who are uncertain about the categorization of a fee *"may"* disclose the fee.[70] The Board appears to be delegating to creditors its role as arbiter of what fees must be disclosed and what need not be. This rule may shield creditors from litigation risk, but it does not to promote uniformity in disclosure or informed consent. The purpose of TILA's disclosure is not to protect creditors from litigation risk; it is to ensure cost of credit information is provided to consumers. The Board can and should do better.

Consumers need information about the cost of credit to enable them to make informed choices. Allowing creditors to freely add fees without disclosure is an invitation to abuse. The Board must set some outer boundaries to curb creditor circumvention of disclosure requirements. At a minimum, undisclosed fees should be capped at some dollar amount.

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[67] 74 Fed. Reg. 43,428, 43,499 (Aug. 26, 2009).
[68] 74 Fed. Reg. 43,428, 43,500 (Aug. 26, 2009).
[69] 74 Fed. Reg. 43,428, 43,505 (Aug. 26, 2009).
[70] 74 Fed. Reg. 43,428, 43,598 (Proposed Official Staff Commentary § 226.6(a)(3)(ii)-3) (Aug. 26, 2009).

b. *The Category of Other Charges Imposed Lacks Clarity*

It is not clear the extent to which the new category of "charges imposed as part of home equity plans" depends on the finance charge definition. The new category on its face includes finance charge fees as defined under Regulation Z § 226.4(a) and (b). The treatment of the exclusions created by Regulation Z § 226.4(c)–(f) is much less clear. Some of these categories are required to be disclosed as part of the "other charges imposed" category, for example voluntary credit insurance. On the other hand, Proposed Official Staff Commentary § 226.4(c)(7) excludes the real estate fee exclusions. A straightforward incorporation of the finance definition as set forth in Regulation Z § 226.4 in its entirety would provide greater clarity. Additional clarity and consistency in the Board's definition of terms would aid compliance.

We appreciate the Board's movement to a more inclusive disclosure of all fees charged under the plan, in line with the underlying statutory framework. We urge the Board to go further and make the cost of credit disclosures for HELOCs truly comparable to closed-end mortgage credit. For both, the finance charge and APR should be all-in.

III. "EARLY" AND ACCOUNT OPENING DISCLOSURES—§§ 226.5b and 226.6

The Board's approach to HELOC disclosures is a recipe for abuse that could harm consumers and undermine the Board's innovative proposal for closed-end credit. Information about both forms of home-secured credit must be provided on similar forms, based on similar rules for what fees are included, and on the same timing schedule. As the HELOC proposal is very different in these regards from the closed-end rules, major revision is necessary.

The Board has overlooked the subprime market where borrowers do not voluntarily seek HELOCs, but instead primarily have HELOCs forced upon them at the last minute in 80-20 financing packages. Without early disclosure these borrowers will not be provided any information before closing about the costs and risks of the HELOCs which will then often be fully drawn at closing—locking them in. Even though consumers suffer the greatest abuse in this segment of the market, the Board proposes a regulatory scheme that continues to allow creditors to withhold loan specific disclosures until the closing and persists in using an APR that cannot be compared to the APR on closed-end credit.

The Board notes that the purpose of the Home Equity Loan Act was to address concerns that under the pre-1988 law, "a consumer may never be advised about the essential features of his or her home-equity loan until it's time to sign the full agreement."[71] Yet this is exactly the regime to which the Board is proposing to return.

[71] Remarks of Rep. Price on H.R. 3011, the Home Equity Loan Consumer Protection Act of 1988, Pub. L. No. 10-709, *enacted on* Nov. 23, 1988, Cong. Rec. H4472 (June 20, 1988), *quoted in the Board's HELOC proposal at* 74 Fed. Reg. 43,428, 43,451 (Aug. 26, 2009).

The proposed regulations will confuse consumers who unknowingly compare closed-end and open-end APRs, and will facilitate even more bait and switch tactics. HELOCs that are used to purchase a home will not be rescindable, so home purchasers who sign a full-drawn HELOC at closing will have no ability to get out of it. Brokers will be able to show borrowers the HELOC APR, which will look good to the borrower because it will be lower than the APR for closed-end products. Lenders could even offer a consumer a plain-vanilla fixed-rate closed-end loan to purchase a home, and then switch the borrower to a subprime HELOC at closing. Bad lending will migrate to HELOCs, undermining the true reforms that the Board has proposed for closed-end lending.

A. *The Board's Proposal to Dispense with Pre-Closing HELOC Disclosures Is an Invitation to Abuse*

Under the current rule, disclosures must be provided to the borrower at the time the borrower is given a HELOC application.[72] The Board is proposing to eliminate all disclosures at this stage except for a one-page document listing questions the borrower should ask about a HELOC. Instead, the borrower will receive disclosures about the HELOC for which he or she is applying only *three days after the creditor's receipt of the consumer's application, but no later than account opening*.[73]

The Board recognizes that, under this proposal, account opening could occur sooner than three business days after application. The Board acknowledges that, in that event, under the proposal, the creditor would be required to provide both the "early" HELOC disclosures and the account-opening disclosures only at closing.[74] Yet, inexplicably, the Board expresses no concern about this scenario.

Instead, the Board states that it anticipates that "in most cases account opening will not occur prior to three business days after application, and the early HELOC disclosures will be given at least some days in advance of account opening."[75] It offers no evidence to support this rosy view.

The Board has solicited comment on how frequently account opening occurs within three days of the consumer's application.[76] The question the Board should be asking is not what the current practice is, but what the practice will be if creditors must make advance disclosures for closed-end loans, but can avoid advance HELOC disclosures by scheduling account opening for less than three days after application.

The answer is that if the Board allows creditors to avoid advance disclosures by the simple expedient of scheduling the closing shortly after receipt of the consumer's application, they will. The Board's proposed HELOC rules provide a roadmap for predatory lenders to lead borrowers into loans without disclosing their terms. Creditors

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[72] Regulation Z § 226.5b(b).
[73] Proposed Regulation Z § 226.5b(b)(1).
[74] 74 Fed. Reg. 43,428, 43,451 (Aug. 26, 2009).
[75] 74 Fed. Reg. 43,428, 43,451 (Aug. 26, 2009).
[76] 74 Fed. Reg. 43,428, 43,452 (Aug. 26, 2009).

may even try to portray HELOCs as speedier, and market this feature as a reason that consumers should prefer HELOCs over closed-end loans.

The Board's abandonment of any requirement for early disclosure appears to be based on a false dichotomy. The Board notes that borrowers prefer loan-specific disclosures over generic disclosures.[77] That fact does not mean that they should get *only* loan-specific disclosures. In the closed-end ARM context, the Board has devised informative loan program disclosures, and requires them to be given to consumers in addition to transaction-specific disclosures. It could do the same for HELOCs. Without HELOC program disclosures at application, consumers will be applying for HELOCs blind, without any information about their terms. The absence of disclosures at application would be particularly problematic given the overwhelming evidence that consumers do not shop for credit once they become committed to a particular lender. Further, even if the Board replaces the generic HELOC program disclosures with loan-specific disclosures, there is no justification for allowing them to be given only at closing.

The only other justification that the Board even suggests for abandoning any requirement of pre-closing disclosure is that consumers may want to draw down their HELOCs quickly.[78] But this rationale would justify abandonment of all pre-closing disclosure requirements, not just for HELOCs but for all credit. When a consumer is getting a complex loan product and putting his or her home on the line, a three-day waiting period is good protection, not too much to ask.

The consumer's right to a refund is another reason why the Board's timing rules must be changed to ensure that the consumer receives the "early" disclosures at least three days before closing. Under both the current version and the proposed revision of Regulation Z § 226.5b(e), a consumer is entitled to a refund of all fees if the consumer decides not to go through with a HELOC during the three days after the consumer receives the early disclosures. Under the Board's proposal, the right to a refund of all fees *will continue even after closing* whenever the early disclosures are provided at closing or less than three days before closing. This result would be unworkable. Where the HELOC was used to fund a home purchase—a common scenario with 80-20 HELOCs—there would be no right to rescind the transaction, and the lender will have already disbursed the loan proceeds. Either the lender would deny the right to a refund, or the consumer would be entitled to the very same loan without the fees (a possibility most creditors would refuse to accept). The right to a refund of fees is an important substantive right for HELOC borrowers, and an important safeguard against bait-and-switch tactics. The Board must revise its proposed timing rules to preserve the right to a refund.

We commend the Board for the time and effort it has put into revising and reformatting the early HELOC disclosures. All of this work will serve no purpose, however, if the Board allows the disclosures to be given at closing. To avoid rendering

[77] 74 Fed. Reg. 43,428, 43,451 (Aug. 26, 2009).
[78] 74 Fed. Reg. 43,428, 43,450 (Aug. 26, 2009).

the HELOC disclosure rules meaningless, the Board must revise Proposed Regulation Z § 226.5b(b)(1) to read:

> ***Timing*. The disclosures required by paragraph (c) of this section shall be delivered or mailed not later than account opening, or three business days following receipt of a consumer's application by the creditor, whichever is earlier, *but the consumer shall, in no event, receive the disclosures less than three days before account opening*.**

Without such a revision, it will be a misnomer to term these disclosures "early." "Early" disclosures that can be given only at closing should not even be termed "early." An even more effective approach would be to follow the Board's closed-end proposal by requiring creditors to provide the *final*, account opening disclosures in advance of closing. That will give homeowners a sufficient opportunity to identify and address changes the creditor may have made. As the Board has recognized, the closing is usually too late for a consumer to back-out of a loan even where the consumer discovers significant changes from the early disclosures.

B. *The Proposed "Key Questions" Disclosure Highlights the Problem with Using a Different Disclosure Regime for HELOCs and Home Equity Loans*

The Board has proposed requiring creditors to provide a "Key Questions" document to consumers at the time they apply for a HELOC.[79] We support the "Key Questions" format, which has the potential for giving consumers concise, relevant information. However, the Board fails to explain in the "Key Questions" document the difference between how the APRs are calculated for HELOCs and home equity loans. Even with that explanation—which we believe would be too complicated to provide in a consumer-friendly format—it is impossible for consumers to compare closed-end and open-end credit.[80]

The "Key Questions" document provides no information for consumers to use to compare the real price of HELOCs to home equity loans. In order for the "Key Questions" document to be of use to consumers who most need it—consumers who are not shopping for a HELOC and are most vulnerable to having an unaffordable or disadvantageous HELOC foisted on them—the "Key Questions" document should be revised to address the significant differences between the two loan types. Or better yet, the disclosure regime for HELOCs should be made analogous to the disclosures for closed-end home secured loans, which would make the current "Key Questions" document accurate and helpful.

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[79] Proposed Regulation Z § 226.5b(a).

[80] The Board expresses concern for consumers who mistakenly believe they were applying for home equity loans, only to receive HELOCs, 74 Fed. Reg. 43,428, 43,460 (Aug. 26, 2009), but has missed the greater problem of consumers who are expecting closed-end home purchase or refinance loans rather than HELOCs.

C. *The Board's Format Proposals for HELOC Disclosures Could Be a Significant Improvement*

1. Introduction

The Board's proposals regarding the format of the early and account opening HELOC disclosures have the potential to help consumers better understand HELOCs terms, and to help consumers avoid risky, unwanted loan terms. In particular, the Board's decision to be more prescriptive regarding the format of these disclosures, and its use of consumer testing to devise more easily-understood disclosures, are commendable. However, it must be stressed that without a requirement that the early disclosures be given before closing, they will be useless.

2. The Board's More Prescriptive Approach to the Format and Phrasing of HELOC Disclosures Is an Improvement But Needs to Be Strengthened

The Board proposes to require creditors to present the HELOC disclosures in tabular form, with substantially the same headings, content and format as the model forms.[81] We strongly support the Board's decision to be more prescriptive regarding the format and phrasing of the disclosures.

We also strongly support the Board's proposal to require a consistent disclosure format at all stages of a HELOC transaction. By doing so, the Board makes it easier for consumers to compare the initial disclosures to the final disclosures and deter bait-and-switch tactics. However, as noted in Section III.A, unless the Board requires the "early" HELOC disclosures to be given prior to closing, the revised format requirements will do nothing to deter bait-and-switch tactics.

The Board's decision to require HELOC disclosures to be presented in tabular format rather than narrative form is particularly important. The Board's consumer testing makes it clear that the existing HELOC application disclosures, which are in narrative form, have been unintelligible and useless to consumers.[82] The Board's proposed format requirements have the potential to transform unintelligible disclosures into disclosures that at least some consumers understand at least in part.

We also support the Board's decision to specify that certain disclosures be in bold text.[83] Use of bold text to highlight certain items helps consumers navigate through a disclosure statement.

The Board's proposal to require creditors to disclose the APR in bold 16-point type is also sound.[84] In particular, we support the requirement to disclose the fully-

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[81] Proposed Regulation Z § 226.5b(b)(2).
[82] ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 7–8 (July 16, 2009).
[83] Proposed Regulation Z § 226.5b(b)(2)(vi).
[84] Proposed Regulation Z § 226.5b(b)(2)(B), (c)(10).

indexed rate in 16-point bold type if the initial APR is an introductory rate. However, when the initial rate is a discounted introductory rate, we urge the Board to require that it be disclosed slightly less prominently, for example in 12-point or 14-point bold type. It is important that consumers be most aware of the fully-indexed rate, and not be distracted by a teaser rate.

We also support the Board's proposal to impose new requirements regarding the order in which disclosures must appear, and to base these requirements on consumer testing and graphic design principles.[85] However, these requirements are too weak. They appear to be limited to rules about what must appear in the table and what must appear directly above and below the table, without any specification of the order in which the items in the table must appear. The Board has spent considerable effort to design a model form that presents the tabular disclosures in a logical order. It should require creditors to adhere to this order. Without such a requirement, creditors will be free to shift disclosures about disadvantageous loan features to less prominent spots, and consumers will find it much more difficult to compare two loan offers side-by-side.

In addition, we urge the Board to be more prescriptive about the phrasing and headings that creditors must use. The Board proposes to require specific phrasing for a few terms,[86] but most of the disclosures need only be "substantially similar" to the model forms in headings, content, and format.[87]

It is not even completely clear whether the requirement that the "content" of the disclosures be substantially similar to the model forms means that the *language* used, as opposed to the subject matter covered, must be substantially similar. Especially for high-risk, counter-intuitive loan features such as negative amortization, the Board should mandate that creditors use *language* that is substantially similar—or, better yet, identical—to that on the model form. These disclosures are so difficult for consumers to understand and absorb that even small phrasing changes could dramatically reduce their understandability and enable creditors to downplay disadvantageous loan features. If the Board crafts the language through consumer testing, it should not allow creditors to vary that language.

In addition, the Board should not allow creditors the option of either referring consumers to information outside the table or telling them to ask for further information. It has taken this approach regarding the conditions under which the plan may be terminated[88] and certain fees.[89] To promote uniformity, the Board should adopt a rule one way or the other. In both of these instances, the Board should require the information to be included in the disclosure statement, even if it is outside the table.

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[85] Proposed Regulation Z § 226.5b(b)(2). *See* 74 Fed. Reg. 43,428, 43,453–43,454 (Aug. 26, 2009).
[86] Proposed Regulation Z § 226.5(a)(2) (requiring use of terms "borrowing period," "repayment period," and "balloon payment," and the term "required" if credit insurance or related products are required).
[87] Proposed Regulation Z § 226.5b(b). *See also* Proposed Official Staff Commentary § 226.5b(b)(2)-1 (headings, content, and format "need not be identical" to model forms).
[88] Proposed Regulation Z § 226.5b(c)(7).
[89] Proposed Regulation Z § 226.5b(c)(14).

3. The Board is Correct to Require the "Early" HELOC Disclosures to Be Provided in Retainable Form

Under the current rule, the disclosures provided with the HELOC application need not be provided in a form the consumer can keep. As part of its shift away from application disclosures, the Board proposes to require the "early" HELOC disclosures to be provided in a retainable form. We support this change.

Although the Board's proposed timing rules will make "early" HELOC disclosures useless (because creditors will be allowed to provide them for the first time at closing),[90] if the Board corrects the timing rules so consumers will actually receive disclosures before closing, the early disclosures will give consumers the opportunity to comparison shop and will help them avoid bait-and-switch tactics. Those goals will, however, be realized only if the disclosures are provided in a form the consumer can keep. Creating a system in which consumers are expected to make a trip to a copy store or library and pay to make photocopies would mean, in effect, that the information was provided in a form that the consumer could not keep.

D. *The Board's Proposals Regarding the Content of HELOC Disclosures Could Improve Them Greatly*

1. Introduction

The Board's proposals regarding the content of the HELOC disclosures have the potential to improve consumer understanding of these loan products. In particular, we commend the Board for its proposal to require the creditor to disclose the payment amount and term that will apply if the consumer draws the full amount at account opening is a major improvement. We also applaud the proposal to require the total dollar amount of all creditor-imposed and third-party fees to be disclosed. As detailed below, many of the other proposed disclosures are significant improvements, and others have the potential to be beneficial with certain revisions. If the Board corrects the proposed timing rules so that consumers receive the "early" disclosures before closing, its proposed substantive changes to the disclosure rules could be very beneficial.

Selected proposals regarding content of the disclosures are discussed below.

2. The Board Is Right to Require HELOC Creditors to Disclose Their Identification Information

The Board has proposed that HELOC creditors be required to disclose their identities, including the loan originator's unique identifier under the SAFE Act.[91] We support this proposal. Mortgage brokers have often failed to make it clear to consumers that they are brokers rather than representatives of the lenders whose loans they arrange. The Board's proposal may help consumers understand what entity they are dealing with.

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[90] As discussed in Section III.A.

[91] Proposed Regulation Z § 226.5b(c)(1).

The Board asks whether it should require creditors to disclose their contact information as well.[92] We encourage the Board to require this disclosure. This information is particularly important if, as proposed, the "early" HELOC disclosure suggests that consumers ask questions if they do not understand the disclosures, and ask the creditor for details about other fees and payment plans besides the ones disclosed.

3. The Board Is Right to Require an Explanation That Receiving or Signing the HELOC Disclosures Does Not Commit the Consumer to Accept the Loan

The Board is proposing to require the "early" HELOC disclosure statement to include a statement that the consumer is not bound to accept the loan, and that any signature merely confirms receipt of the disclosure statement.[93] We support this proposal. However, we urge the Board to clarify the proposed language. A clearer, less legalistic phrasing would be:

> You are not required to take this loan. You may still shop somewhere else. [Signing on the line below only says you received this form.]

We also urge the Board to require creditors to use the exact phrasing of this disclosure, not merely "substantially similar" language as would be required by Proposed Regulation Z § 226.5b(b)(2). Once the Board has completed consumer testing, creditors should not be allowed to revise this disclosure to soft-pedal it.

4. Requiring Creditors to Disclose That the Consumer Has Applied for a HELOC Is an Improvement

The Board proposes to require creditors to disclose that the consumer has applied for a HELOC.[94] We support this proposal. Particularly in 80-20 loans, consumers are often completely unaware that they are being given a HELOC. This proposal could help reduce this problem, as long as the Board corrects the enormous gap in its proposed timing requirements that would allow creditors to make this and all other "early" disclosures useless by giving them at closing.

5. The Proposal to Revamp the Disclosure of Terms That Are Subject to Change Is an Improvement, but Additional Improvements Are Necessary

The Board has proposed to require the "early" disclosure form to identify which terms are subject to change.[95] Requiring this disclosure to be placed immediately below each such term will make the information much clearer to consumers.

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[92] 74 Fed. Reg. 43,428, 43,459 (Aug. 26, 2009).
[93] Proposed Regulation Z § 226.5b(c)(2).
[94] Proposed Regulation Z § 226.5b(c)(3).
[95] Proposed Regulation Z § 226.5b(c)(4)(i).

However, in order to make the right to a refund effective, the Board should also require creditors to highlight any changed terms in the final, account-opening disclosures. If the right to a refund depends on consumers having to make a painstaking review of the early and final disclosures, it is much less likely to be effective. By contrast, modern word processing technology makes it simple for creditors to highlight terms that have changed from one document to another.[96]

In addition, the creditor should be required to provide the final disclosures with the changed terms some period of time before closing. Otherwise, even if the consumer gets the "early" disclosures before closing, the consumer is likely to arrive at closing without knowing if any terms have changed. The Board's consumer testing documented that creditors rush consumers through loan closings, and consumers are intimidated by loan closings.[97] Consumers do not have the opportunity to review loan documents at closing in any detail—and sometimes not at all. Given the nature of loan closings, a right to a refund will be an empty promise unless consumers are given the final disclosures in advance. Thus, not only should the Board revise its proposed timing rule to require that the "early" disclosures be given early, but it should also require final disclosures to be given some period before closing.

6. Disclosure of the Payment Terms Based on the Maximum Draw Will Be a Significant Improvement, but the Payment Period Should Always Be Part of the Disclosure

We applaud the Board's proposal to require creditors to disclose the payment terms that will apply if the consumer borrows the maximum credit line available at account opening. This and the new format requirements for HELOC disclosures are the two most significant improvements the Board has proposed.

The proposed new requirement is a big step toward narrowing the information gap between HELOC and closed-end disclosures. The absence of disclosures regarding the actual payment schedule has been one of the key gaps that creditors have exploited when offering open-end credit. This disclosure is particularly important for 80-20 HELOCs, which are the kind of HELOCs that advocates for low-income consumers typically see. In 80-20 transactions, the credit line is completely or almost completely drawn down at closing. The loan functions as a closed-end transaction, but without the closed-end disclosures.

The proposal requires one major improvement, however: the Board should require the *length* of the repayment period to be disclosed as part of the payment schedule table. The length of the repayment period appears in the payment schedule table on Model Forms G-14(C) and (E), but that appears to be because they illustrate loans that have different payment amounts for the draw period and repayment period. On Model

[96] The need to highlight changes is more thoroughly discussed in Section VI.C.3 of our comments on the Board's closed-end proposal, which is attached as Appendix I to these comments.
[97] ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 7 (July 16, 2009).

Form G-14(D), the payment schedule table says nothing about the period of time during which the consumer will have to pay $350 per month (or $1,666 if the interest rate rises to its maximum). Obviously, it is enormously important to a consumer to know whether this is a one-year or 20-year obligation. It is also critical information if the consumer is to compare a HELOC to a closed-end loan.

We recognize that a different part of the proposed disclosure form states the length of the plan.[98] However, that disclosure will be separated from the payment schedule table by a large amount of other text, so it will be difficult for consumers to tie the two pieces of information together. In addition, if the length of the plan depends on the amount borrowed, the proposed rule allows the creditor merely to state that fact, so there would be no disclosure of the actual length of the repayment period if the consumer borrowed the maximum amount at closing.[99]

For these reasons, the Board should revise Model Form G-14(D) to indicate the length of the repayment period in the payment schedule table, and should revise the proposed regulation to require this information to appear there.

We are also concerned about the use of the term "First Payment" in the payment schedule table. The use of this term will raise too many questions in consumers' minds, as it implies that other payments will be different, but provides no information about this question. It does not even state whether payments will increase or decrease. If the repayment period has built-in increases in the payment amount, disclosing only the initial payment amount is woefully inadequate. For example, the repayment period could be structured to begin at an artificially low amount, or even a negatively amortizing amount, and then increase. If consumers are not informed of these features of the payment schedule, the disclosure of the amount of the first payment will be misleading. Indeed, allowing creditors to disclose only the amount of the first payment encourages creditors to structure loans to have built-in but hidden payment increases.

In one of the rounds of testing, ICF Macros added an explanation of why HELOC payments might decrease during the repayment period: "During the repayment period, your minimum monthly payment will decrease over time as your principal balance is paid down." Almost all participants understood this disclosure.[100] We urge the Board to require this disclosure when it is in fact true. If the HELOC is structured so that payments do not decrease as the balance decreases, or so that there are built-in step increases in the payment amount, the creditor should be required to make disclosures that reflect these terms. The Board's disclosure requirements should not be structured around the payment terms currently prevalent in the HELOC market, but should be flexible enough to apply to variants that might develop. Recent history demonstrates that creditors can be remarkably creative in devising new loan products that take advantage of gaps in disclosure rules.

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[98] Proposed Regulation Z § 226.5b(c)(9)(i).
[99] Proposed Official Staff Commentary § 226.5b(c)(9)(i)-1.
[100] ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 27 and Form AO-2 (July 16, 2009).

7. The Board's Proposed Disclosures Regarding HELOC Payment Schedules Represent a Good Effort to Present Excessively Complex Information, but the Board Should Take Additional Steps to Simplify This Disclosure

The Board has proposed a number of disclosures regarding HELOC payment schedules.[101] As noted in the preceding section, we strongly support the proposal to require disclosure of the payment amount and term that will apply if the consumer draws the full line of credit at account opening.

We commend the Board for giving greater prominence to balloon payment disclosures and requiring creditors to state that a balloon payment "will" rather than "may" occur in transactions where making the minimum payment will result in a balloon payment.[102] We strongly support the proposal to require that the dollar amount of the balloon payment be disclosed.[103] Balloon payments vary greatly, from a payment only double the size of an ordinary payment to the entire principal. The amount of the balloon payment is therefore of enormous importance to consumers. Giving a dollar figure for the balloon payment also makes the disclosure much more concrete.

The other payment schedule disclosures are exceedingly complex. We recognize the difficulty of presenting coherent, understandable information when the product itself is so complex, with so many options and requirements. The Board has made a good effort to present this information in a way that consumers can understand. However, we urge the Board to take additional steps that may make more understandable disclosures possible.

First, the Board is proposing to delete a Commentary provision, Official Staff Commentary § 226.5b(a)(1)-4, that allows creditors who offer more than one HELOC plan to disclose all of them on a single form. However, the Board has not clearly prohibited disclosure of multiple HELOC plans on the same form. Instead, it has merely limited the number of payment options that HELOC lenders can disclose on a single form.[104] We urge the Board to adopt an affirmative prohibition against disclosing multiple HELOC plans on the same form (although creditors could still disclose two payment options for a single plan). Such a prohibition would help reduce the complexity of the disclosures.

Without such a prohibition the HELOC disclosures could easily become meaningless. For example, if a single form was used to disclose that a creditor offered plans with and without early termination penalties, and with and without an introductory

[101] Proposed Regulation Z § 226.5b(c)(9).
[102] Proposed Regulation Z § 226.5b(c)(9)(B)(1), (3).
[103] Proposed Regulation Z § 226.5b(c)(9)(iii)(C)(4).
[104] Proposed Regulation Z § 226.5b(c)(9)(B). *See* 74 Fed. Reg. 43,428, 43,456 (Aug. 26, 2009).

rate, the consumer would not be able to tell whether the plan with the introductory rate had an early termination penalty.[105]

Second, our general position is that if a product or feature is so complex that consumers cannot understand it, disclosure is an ineffective approach and the product should be substantively regulated instead. We urge the Board to impose additional substantive regulation on HELOCs. For example, the Board should prohibit negatively-amortizing payment schedules. It should also consider prohibiting or restricting balloon payments.

8. The Board Is Wise to Propose Limits on Penalty Rates, but Its Reasoning Regarding Their Disclosure Is Unsound

The Board proposes allowing creditors to impose penalty rates only when a payment is 30 days late or more.[106] We commend the Board for proposing to restrict the imposition of penalty rates (although, as discussed in Section IV.C of these comments, we question whether the actual proposed language succeeds in accomplishing this result). Recent history in the credit card context demonstrates that when creditors are allowed to impose penalty rates, some will do so on the flimsiest of justifications, such as a consumer's late payment on a different obligation, or a drop in the consumer's credit score. Since a consumer's home is at stake with a HELOC, it is all the more important to limit the creditor's ability to impose a penalty rate.

However, we disagree with the Board's proposal not to require disclosure of penalty rates.[107] The Board bases this proposal on the fact that penalty rates will be allowed only in limited circumstances, and its conclusion that most HELOC creditors today do not impose them.[108] This reasoning is unsound. First, many consumers will be 30 days late in a HELOC payment. This is particularly true for lower-income consumers. Second, the Board is wrong to base disclosure rules on what is prevalent in the HELOC market today. We are concerned the gaps and loopholes in the Board's proposed HELOC rule will create an incentive for the bad parts of the mortgage market to move to HELOCs. Abusive penalty rates could very well become a part of subprime HELOCs, just as they became common in credit cards.

Consumer outrage over penalty rates in the credit card context has made consumers more aware of them, and possibly more sensitive to them when they consider applying for credit. Requiring disclosure of the amount of any penalty rate might deter some consumers from entering into HELOC transactions that carry high penalty rates. It also might create downward pressure on penalty rates. By contrast, if the penalty rate need not be disclosed, creditors will have an incentive to impose high penalty rates. The

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[105] The Commentary section that the Board is proposing to repeal recognizes this problem by requiring creditors to disclose how plan features are linked. Current Official Staff Commentary § 226.5b(a)(1)-4.
[106] *See* 74 Fed. Reg. 43,428, 43,473 (Aug. 26, 2009).
[107] Proposed Regulation Z § 226.5b(c)(10).
[108] 74 Fed. Reg. 43,428, 43,473 (Aug. 26, 2009).

penalty rate will create a built-in revenue increase, as the creditor can count on a certain number of consumers making late payments.

9. The Board Should Require Use of the Term "Adjustable Rate" Rather Than "Variable Rate"

The Board's consumer testing showed that consumers are familiar with the term "adjustable rate" but not "variable rate."[109] Accordingly, the Board has proposed requiring closed-end creditors to use the term "adjustable rate" in disclosures. Proposed Regulation Z § 226.19(b).[110] For HELOCs, however, the Board proposes requiring creditors to use the term "variable rate."[111]

This does not make sense. Not only is "variable rate" less well understood, but it is confusing to use one term in the closed-end context, and a different term for the same loan feature in the HELOC context. Consumer testing shows that consumers understand disclosures better when the format and terminology is consistent from one disclosure to another.[112] For these reasons, the Board should require the use of the term "adjustable rate" in the HELOC context, just as it is proposing to require that term in the closed-end context.

10. The Board's Proposal for Disclosing the Current Index Rate Makes Sense for Early Disclosures, but Final Disclosures Should Be Different

The Board is proposing to prohibit creditors from disclosing the current index rate in the table.[113] Instead, creditors would be required to identify the index rate using a term such as "prime rate." We agree with this proposal. The marginal value of disclosing the current value of the index rate is slight, since consumers will already be given the APR for their loan. Providing the value of the index rate risks distracting or confusing consumers.

We also agree with the Board's proposal that creditors should not be allowed to include in the table a reference to a source of information about the index.[114] This information is unlikely to be of use to consumers shopping for a HELOC. However, we recommend that this information be required in the final disclosures. Once a consumer has entered into a HELOC, it is important to be able to check the index rate in order to monitor the creditor's compliance with the adjustable rate calculations. The Board should revise Proposed Regulation Z § 226.6(a)(2)(vi)(A) to require the creditor to include a source of information about the index rate in the final disclosure.

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[109] ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 12 (July 16, 2009).
[110] See 74 Fed. Reg. 43,232, 43,265 (Aug. 26, 2009).
[111] Proposed Regulation Z § 226.5b(c)(10)(i)(A)(1).
[112] ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 23 (July 16, 2009).
[113] 74 Fed. Reg. 43,428, 43,475 (Aug. 26, 2009).
[114] 74 Fed. Reg. 43,428, 43,475 (Aug. 26, 2009).

In addition, we urge the Board to adopt a substantive rule that allows lenders to use an index rate only if the current and historical rates are available to consumers through an authoritative public source that is *free of charge*. This is necessary because the LIBOR rates, which have been widely used as an index for subprime ARMs, are no longer available from an authoritative source free of charge. Creditors should not be allowed to use an index rate that consumers must pay to access.

11. The Board Is Correct to Require Disclosure of the Maximum APRs for Each Payment Option

Current Official Staff Commentary § 226.5b(d)(12)(ix)-3 provides that a creditor need not disclose each rate cap that is available, but may disclose the range of rate caps it offers. The Board proposes replacing this lax rule with a requirement that the creditor disclose the rate cap for each payment option offered in a HELOC.[115] We agree with this proposal. The true maximum is an extremely important piece of information, and the Board's proposal will give more precise information about it to consumers. It is also important to the stability of our economic system that borrowers have solid information about the level of risk they are taking on. Merely providing a range of APR caps is insufficient.

The Board also proposes requiring disclosure of the periodic limits on rate increases. We support this proposal, although we view this disclosure as less critical than the maximum APR disclosure, as long as the payment disclosures are based on the maximum rate and maximum draw—the worst case scenario.

12. Consumer Testing Provides Compelling Reasons to Delete the Table of Historical Rates

Under the current rule, the creditor is required to disclose a table showing how changes in the index rate over the previous 15 years would have affected the consumer's interest rate and minimum payment.[116] The Board is proposing to replace this disclosure with a requirement that the creditor disclose just the highest and lowest index rate over the previous 15 years.[117]

We support this proposal. The Board's consumer testing has shown that consumers do not understand the current 15-year disclosure.[118] The fact that this historical disclosure uses a hypothetical $10,000 loan makes it even more likely to confuse consumers.

Even if consumers understood it, the current disclosure provides far too much information. The exact amounts that the consumer's APR and minimum payment could

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[115] Proposed Regulation Z § 226.5b(c)(10)(i)(A)(5). *See* 74 Fed. Reg. 43,428, 43,476 (Aug. 26, 2009).
[116] Current Regulation Z § 226.5b(d)(12)(xi).
[117] Proposed Regulation Z § 226.5b(c)(10)(i)(A)(6). *See* 74 Fed. Reg. 43,428, 43,477 (Aug. 26, 2009).
[118] ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit, at vi (July 16, 2009).

have been over the past 15 years, at every change date, is of very little relevance even to a consumer who understands that this is a hypothetical historical example. Providing the range—the high and low amounts—provides just as much usable information.

As to the question of whether to require disclosure of the historical range in index rates or the effect that those changes would have had on the consumer's APR, we urge the Board to adopt the approach that is simplest, easiest to phrase concisely, and least likely to confuse consumers. Our view is that disclosing the range in index rates rather than the consumer's own rate probably meets these goals best. The reference to the historical range of the index can be expressed as a fact, not as a hypothetical application of historical rates to a transaction as if it had occurred in the past, so is a simpler concept to present. However, we urge the Board to test the alternate approaches through consumer testing.

13. The Proposal to Require Disclosure of Current APRs Offered Is an Improvement

The Board proposes requiring the "early" disclosures to include the current APRs offered to consumers.[119] This change would be a significant improvement over the current rule. For fixed-rate HELOCs, the current rule requires only a disclosure of a recent APR that has been in effect sometime within the preceding twelve months—information that is largely irrelevant and possibly misleading.[120] We also agree with the related proposal to delete the statement that the consumer should ask the creditor about current rates.[121] This disclosure will be surplusage once the creditor is required to disclose the actual rates offered. However, the Board should consider replacing this disclosure with a statement encouraging the consumer to ask other lenders for better rates. Such a statement would help meet TILA's goal of encouraging comparison shopping.

14. The Board's Proposal to Dispense with the Statement That HELOC APRs Only Include Interest Will Compound the Board's Erroneous Approach to HELOC APRs

Under the current rule, the HELOC disclosures given at application must include a statement that the APR does not include costs other than interest.[122] The Board is proposing to delete this requirement, even though it is also one of TILA's statutory mandates.[123]

The Board has already made a bad decision in proposing to allow HELOC lenders to base the APR disclosure solely on the interest rate, without including any fees. If consumers only compared HELOCs to credit cards, using the same definition of APR for

[119] Proposed Regulation Z § 226.5b(c)(10).
[120] Current Regulation Z § 226.5b(d)(6).
[121] 74 Fed. Reg. 43,428, 43,478 (Aug. 26, 2009).
[122] Regulation Z § 226.5b(d)(6).
[123] 15 U.S.C. § 1637a(a)(2)(A), (C). *See* 74 Fed. Reg. 43,428, 43,450 (Aug. 26, 2009).

both of those products might make sense.[124] *But consumers will compare HELOCs to closed-end mortgages*. In fact, HELOCs have often been used as substitutes for fixed-rate mortgages for home purchases and refinance transactions, particularly in 80-20 transactions. Allowing creditors to disclose an interest-only APR for HELOCs will give HELOC lenders an unfair competitive advantage because they will be able to portray HELOCs as less expensive than closed-end loans *when in fact they may be more expensive*.

In our experience, low-income consumers do not seek out HELOCs. Instead, HELOCs are presented to them as part of 80-20 home purchase or refinance transactions. The HELOC does not operate as an alternative to a credit card, but as an alternative to, or as part of, a closed-end mortgage transaction. The Board's decision to allow creditors to disclose APRs that do not include fees in HELOCs while using the same term, "APR," invites fraud and confusion.

The Board's proposal to delete the statement that the HELOC APR does not include costs other than interest only makes this decision worse. This proposal would delete the consumer's only clue that the disclosed HELOC APR might be different from the closed-end APR. We recognize that the Board's consumer testing has shown that consumers have not understand the statement that the HELOC APR does not include costs other than interest.[125] However, none of the consumer testing sessions asked consumers to compare a HELOC APR to a closed-end APR. In that context, even if consumers did not understand anything else about the disclosure, they would probably have understood that the two so-called APRs meant different things and could not be compared. Before it makes a final decision about this issue, we urge the Board to conduct consumer testing that asks consumers to compare HELOCs with closed-end loans.

The Board has also spent considerable effort documenting that consumers do not understand why an APR might be higher than an interest rate, and cites this fact as a justification for deleting the statement in question.[126] Whether consumers can understand or explain how an APR is calculated is entirely irrelevant, however. A consumer can understand that a higher trans fat content in food is bad without understanding what trans fat is, how it is different from other fats, how trans fat content is calculated, or even what a gram is. The consumer only needs to know that a higher number is worse than a lower number. The same is true for the APR.

The most important fact about a HELOC for a consumer is that, as with a closed-end mortgage transaction, the consumer's home is on the line. For this reason, HELOCs should be treated like other mortgage transactions, not like credit card transactions. The proposed HELOC APR definition should be revised to include all fees. But even if the

[124] However, even for credit cards we strongly disagree with the Board's decision to treat the interest rate as the APR and exclude all other finance charges.
[125] ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 10, 17 (July 16, 2009).
[126] 74 Fed. Reg. 43,428, 43,478 (Aug. 26, 2009); ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit, at iv (July 16, 2009).

Board keeps the flawed APR definition for HELOCs, it should require creditors to use a different term, such as "interest rate," when making the disclosure. If a federal agency allows creditors to use the same term to mean two different things for competing products, consumers will have no reason to suspect that they are comparing apples to oranges. The Board's approach to the APR for HELOCs directly contradicts its own consumer testing regarding the use of similar terminology.[127] The proposal to use the term "APR" for closed and open-end mortgages encourages consumers to make an inaccurate comparison. This is a major flaw in the Board's HELOC proposal.

As set forth in Section II of these comments, the Board should make much more fundamental changes to its approach to the HELOC APR disclosure. But at the very least, it must not use the same term to mean two different things without any explanation.

15. Requiring Disclosure of the Dollar Amount Total of One-Time Fees Will Be an Improvement, but the Board's Failure to Require Disclosure of Other Fees Is Dangerous

The Board proposes to require creditors to include the total of all one-time loan fees in the disclosure table. Proposed Regulation Z § 226.5b(c)(11).[128] We commend the Board for this proposal. It is a significant improvement over the current rule, which requires fragmented disclosures depending on whether the fee is charged by the creditor itself or a third party.[129]

We particularly commend the Board for including third-party fees in this requirement. Allowing creditors to evade disclosure requirements by outsourcing loan origination functions only invites abuse. We reiterate our concern, however, that these fees are not captured in the APR. Since the dollar amount must be disclosed at closing, it should not be difficult to include that dollar amount in the APR calculation.

We also applaud the Board's decision to make this disclosure transaction-specific and to require disclosure of these fees as a dollar amount. A dollar amount will be more concrete for consumers. In addition, if some creditors disclose these fees as a percentage, and others as a dollar amount, it will be harder for consumers to compare loan offers.

It is particularly important that consumers see this total well in advance of account opening. This is another reason that the Board should correct its deeply flawed proposal regarding the timing of HELOC "early" disclosures, as discussed in Section III.A of these comments.

We strongly object, however, to the Board's decision not to require disclosure of recurring fees such as transaction fees in the table for the "early" HELOC disclosures, but

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[127] ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit 4 (July 16, 2009) (recommending that disclosures "Keep language … consistent between forms").
[128] *See* 74 Fed. Reg. 43,428, 43,479 (Aug. 26, 2009).
[129] *See* Current Regulation Z § 226.5b(d)(7), (8).

only in the final disclosures.[130] Instead, the Board is proposing to allow creditors to make a vague statement that other fees may apply and, at the creditor's option, to refer the consumer to some part of the disclosure statement other than the table or to tell the consumer to ask about other fees.

This approach would open a dangerous loophole, potentially leading consumers to enter into disadvantageous transactions unknowingly. Experience with credit cards over the past decade shows that there can be at least some limited competition among lenders as to terms for which the law requires prominent disclosure. For example, credit card lenders have prominently touted low APRs and "no annual fee." At the same time, however, credit card lenders dramatically increased fees, such as late fees and over-limit fees, for which prominent disclosure was not required. The result was a more complex product with tricks and traps that were very poorly disclosed, ultimately prompting Congressional hearings, new legislation, and new Regulation Z provisions.

By failing to require disclosure of transaction fees and other similar fees, the Board is inviting similar evasions in the HELOC market. Transaction fees are unlikely to be subject to any cap, so could be set at 50% of every advance, or more. Indeed, the business model of payday lenders is to exploit exactly this sort of loophole: they find an uncapped fee, preferably one that is subject to weak disclosure requirements, and structure their product around it.[131] Predatory HELOC lenders are likely to follow the same approach.

The Board justifies this omission on the ground that some consumers do not plan to take HELOC advances at account opening. 74 Fed. Reg. 43,428, 43,480 (Aug. 26, 2009). This is no justification at all. First, all consumers who open HELOC accounts do so because they intend to borrow money. Whether they will borrow money at account opening or later is irrelevant: they need to be told how much it will cost. Second, even if some consumers do not plan to take HELOC advances at account opening, this does not justify denying this information for the consumers who do plan to take immediate HELOC advances.

The Board's other justification is that consumers find account-opening fees more important than transaction fees.[132] This justification is based on a false premise—that either account-opening fees or transaction fees can be disclosed, but not both. If the Board followed this reasoning to its logical conclusion, it would delete account-opening fees as well if consumers found the interest rate more important, and then it would delete the interest rate if consumers found the payment amount more important, and so on until only one item was disclosed.

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[130] Proposed Regulation Z §§ 226.5b(c)(11), (12), 226.6(a)(2)(xii); 74 Fed. Reg. 43,428, 43,480 (Aug. 26, 2009).

[131] An example is the open-end line of credit that payday lenders introduced in some jurisdictions that attempted to impose interest rate caps on payday loans. For example, in Pennsylvania a payday lender attempted to evade rate caps by offering a $500 line of credit with an interest rate of 5.98% but a $149.95 monthly access fee. Pa. Dep't of Banking v. NCAS of Del., L.L.C., 948 A.2d 752 (Pa. 2008).

[132] 74 Fed. Reg. 43,428, 43,480 (Aug. 26, 2009).

In addition, the consumer testing on which the Board relies for this conclusion was flawed. In the sample disclosures used in the consumer testing, the account opening fees were either "up to $1,700" or "$1,740." By contrast, the transaction fee for a cash advance was disclosed on one sample form as just $2 or 2% of the advance, and the wire transfer fee was just $20 on most of the sample forms.[133] Of course consumers are going to find a $1700 fee more important than a $20 fee. But nothing in the law requires HELOC lenders to charge low transaction fees. To the contrary, weak disclosure requirements for transaction fees will be an incentive for HELOC lenders to move more of the cost of credit into these fees.

We also disagree with the proposed restrictions on disclosing other fees. The Board specifically prohibits creditors from disclosing the amount of required property insurance premiums with the fees imposed to open the plan or for availability of the plan.[134] This prohibition is directly contrary to the requirement to disclose escrow requirements for closed-end mortgages. While creditors usually do not require property insurance when a HELOC is a subordinate lien or is not the first lien on a home, creditors are more likely to do so if the borrower does not otherwise have insurance. Prohibiting creditors from disclosing this expense would mislead consumers about the cost of having a line of credit.

Similarly, the Board has made the proposed list of fees that must be included in the account opening table an exclusive list.[135] The Board did so, in part, based on the belief that an exclusive list would protect creditors from litigation as they developed new services and fees.[136] This is a horrible reason for an ill-conceived restriction. As described by the Board, creditors will not be required to disclose new fees "unless and until the Board requires their disclosure after notice and public comment."[137] This will encourage a proliferation of hidden fees, as consumers have experienced with credit cards. It will also cause the Board to choose between constantly amending the regulations to keep up with creditors' "innovation" or leaving consumers vulnerable to undisclosed fees until the regulations are updated. We encourage the Board to instead develop clear guidelines for disclosing new fees. Regulations that are inflexible will inevitably be overcome by changes in the market. We recognize the lending industry's desire to avoid confusion and litigation, but the Board should balance creditors' need for clear rules with the Board's statutory duty to consumers.

16. Disclosure of Early Termination Fees Is Appropriate

The Board is proposing to require creditors to disclose early termination fees in the table.[138] We support this proposal. Early termination fees are the HELOC equivalent of prepayment penalties, which have been one of the abusive features of subprime closed-

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[133] ICF Macro, Design and Testing of Truth in Lending Disclosures for Home Equity Lines of Credit, at iv-v and forms used on Dec. 16, 2009, Feb. 7, 2009, and Mar. 18, 2009 (July 16, 2009).
[134] Proposed Regulation Z § 226.6(a)(2)(vii)–(viii).
[135] 74 Fed. Reg. 43,499.
[136] 74 Fed. Reg. 43,500.
[137] *Id*.
[138] Proposed Reg. Z § 226.5b(c)(13); *see* 74 Fed. Reg. 43,428, 43,481 (Aug. 26, 2009).

end mortgage loans. Especially in adjustable rate transactions, prepayment penalties can trap consumers in unaffordable loans. A weaker rule saying prepayment penalties need not be prominently disclosed in HELOC transactions, would be an invitation to abusive creditors to move to HELOCs.

We also support the Board's broad definition of early termination penalties to include reimposition of account-opening fees that would otherwise be waived.[139] Reimposition of otherwise-waived fees is a transparent attempt to impose an early termination penalty under another name. Without this broad definition, the Board's disclosure requirement would be easily evaded.

17. The Board's Proposed Negative Amortization Disclosure Is a Step in the Right Direction but Requires Revision

The Board is proposing safe harbor language for the disclosures required when a HELOC allows payments that will result in negative amortization.[140] First, we encourage the Board to *ban* any consumer loan product that permits negative amortization. This recommendation is discussed more thoroughly in Sections II and VII.E.6 of our comments on the Board's closed-end proposal.[141]

If the Board continues to permit negative amortization, the proposed disclosure is certainly an improvement over the current rule. We especially commend the Board for requiring this disclosure whenever the consumer is *allowed* to make payments that will result in negative amortization, not just in cases where the contract terms prohibit the consumer from making amortizing payments. The proposed loan-type disclosures for closed-end mortgage loans misleadingly treat only the latter as negative amortization loans.

We also urge the Board to rephrase the negative amortization disclosure so that it does not tell the consumer that negative amortization will "increase the total amount you are borrowing." Referring to the increase in the loan balance due to negative amortization as additional "borrowing" is an exceedingly confusing choice of language. Worse, it could be misinterpreted by unsophisticated borrowers as an inducement to make the minimum payments—a consumer could read the statement as meaning the lender will give them more cash if they make only the minimum payments. The use of the word "borrow" to describe the effect of negative amortization is vastly different from the common understanding of the word. We urge the Board to test clearer language, such as "the amount you owe will increase."

Finally, we urge the Board to mandate specific language rather than create a safe harbor. The Board's consumer testing shows that consistency in language makes it easier for consumers to understand and absorb information. The possibility of negative

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[139] Proposed Official Staff Commentary § 226.5b(c)(13)-1. *See* 74 Fed. Reg. 43,428, 43,482 (Aug. 26, 2009).
[140] Proposed Official Staff Commentary § 226.5b(c)(15)-1.
[141] Attached as Appendix I to these comments.

amortization makes a loan highly risky. As stated elsewhere in our comments, the Board should ban negatively amortizing consumer mortgage loans. But if it does not take this step, it should at least impose strict requirements for their disclosure. Given the documented difficulty consumers have in understanding negative amortization, the Board should not allow creditors to fiddle with the phrasing of this disclosure.

18. Adding a Requirement to Disclose the Credit Limit Is an Improvement

The Board is proposing to add a requirement that the disclosures include a statement of the credit limit.[142] We support this proposal. For consumers who are actually seeking a HELOC (as opposed to consumers who are unknowingly steered into a HELOC in an 80-20 transaction), the credit limit is a key piece of information. Without a disclosure of the credit limit, a consumer who has specific borrowing needs in mind will not know whether the HELOC will accommodate those needs.

19. The Reference to the Board's Website Will Be Helpful to Consumers

The Board is proposing to require creditors to include a reference to the Board's website in the HELOC disclosures.[143] We support this proposal but note that consumers will not benefit from any pre-closing information on the site if the Board allows creditors to provide the "early" disclosures at closing, for the first time. We urge the Board to provide a specific web address for a web page that contains consumer information about HELOCs, rather than referring consumers to the FRB home page. If consumers have to navigate through the FRB's website to find information about HELOCs, many will give up before they find the information that the Board has posted.

In contrast to its proposed closed-end rule, the Board is not requiring creditors to mention the availability of housing counseling. We question this decision. Even if pre-transaction housing counseling focuses primarily on home purchases, it may be appropriate for HELOC borrowers, since HELOCs have often been used for home purchases as part of 80-20 transactions.

20. The Periodic Rate for a HELOC and the Fact that Rate Information Will Be Provided on Periodic Statements Should Not Be Disclosed

We support the Board's decision that certain information should not be included on the disclosure statement. First, the Board has proposed to prohibit creditors from disclosing periodic rates for HELOCs in the disclosures, requiring instead that the rate be expressed only on an annual basis.[144] We support this proposal, although, as set forth in detail in Section II.B of these comments, we urge the Board to require the disclosure of the true APR, not just the interest rate.

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[142] Proposed Regulation Z § 226.5b(c)(17). *See* 74 Fed. Reg. 43,428, 43,482 (Aug. 26, 2009).
[143] Proposed Regulation Z § 226.5b(c)(21).
[144] 74 Fed. Reg. 43,428, 43,473 (Aug. 26, 2009).

Disclosure of the periodic rate adds nothing to consumer understanding of the cost of credit. It distracts from more relevant disclosures, and creates a risk of confusion, as consumers may not realize that it is not the annual rate. The Board is right to prohibit this disclosure.

Second, the Board has proposed to eliminate the requirement that the HELOC disclosures include a statement that rate information will be provided with each periodic statement.[145] This information is irrelevant to a consumer's decision about whether to obtain a HELOC and will be obvious once the consumer receives a periodic statement. This information merely detracts from other more germane information and the Board is right to delete it.

21. The Board's Proposed Amendments Regarding the Requirement That Fees Be Refunded If Terms Change Will Help Consumers *As Long As* the Board Revises Its Timing Requirements

The Board has proposed an important revision to the requirement that fees be refunded if a creditor changes the terms of a HELOC plan between the time of the "early" disclosures and the time the plan is opened. Proposed Regulation Z § 226.5b(e) would delete language in the current rule that allows the consumer to obtain a refund of fees only if the consumer decides not to open the plan "as a result" of the changes in terms.

The Board is correct in its view that conditioning the consumer's right to a refund of fees on a showing that the change in terms was the cause of the consumer's decision not to open the plan inserts an overly subjective element into what would otherwise be a simple and straightforward right. Limiting the consumer's right to a refund in this way also gives creditors too much room to oppose or delay a refund. For these reasons, we strongly support the Board's proposal.

Clarifying and simplifying the right to a refund whenever a creditor changes the terms that were set forth in the "early" HELOC disclosures will provide some additional deterrence to bait-and-switch tactics. However, if creditors can evade the requirement to give the "early" disclosures at an early point, and can give them at closing, this improvement will not have any beneficial effect. As pointed out elsewhere in these comments, the Board must revise Proposed Regulation Z § 226.5b(b)(1) to require that the "early" disclosures be given before closing. Without such a revision, the other protections against bait-and-switch tactics will be ineffective, and fraudulent lenders will have a powerful incentive to move from closed-end to HELOC lending.

We also strongly support the Board's proposal to require that the consumer's right to a refund be disclosed.[146] Without disclosure, consumers are unlikely to know of this important right, much less exercise it. We urge the Board, however, to require creditors to disclose the date on which the three-day right to a refund expires. The Board is proposing to require creditors to disclose merely that the consumer has the right to back

[145] 74 Fed. Reg. 43,428, 43,478 (Aug. 26, 2009) (repealing current Regulation Z § 226.5b(d)(12)(xii)).
[146] Proposed Regulation Z § 226.5b(c)(4), (5), (22).

out of the transaction and receive a refund by notifying the creditor "within three business days."[147] The definition of "business day" for this purpose is every calendar day except Sundays and certain specified federal holidays.[148] One federal judge has noted, "it would likely surprise the average person (it certainly surprised this judge) to learn that 'Saturday' is included within TILA's definition of a 'business day.'"[149] The Board should place the burden upon the creditor to determine and inform the consumer of the exact deadline.

IV. SUBSEQUENT DISCLOSURES AND SUBSTANTIVE LIMITATIONS—§§ 226.9 and 226.5b

A. *The Board Is Correct to Require Additional Time for Change-in-Term Notices, but Exceptions to the Advance Notice Requirement Should Be Limited*

We support the Board's proposal (Proposed Regulation Z § 226.9(c), (i)) to require creditors to provide written notice of the change in terms at least 45 days before the effective date of the change. The current rule permitting only 15 days' advance notice fails to provide consumers with sufficient time to make adjustments regarding use of the home equity loan and or to consider other financing options. Particularly with respect to significant changes such as the imposition of a penalty interest rate, the additional time is needed by consumers to plan appropriately for the change. Although creditors are not permitted to change terms of HELOCs as easily as for credit cards, the impact of a term change may be more severe with respect to HELOCs since consumers often will have more difficulty obtaining replacement home equity financing.

Proposed Regulation Z § 226.9(j) would require, as under the current rule, that notice of a credit limit reduction or suspension in advances must be sent no later than 3 business days after the action is taken. Given intervening non-business days and delays in receipt, a week or more may pass before a consumer is informed of these significant term changes. Unlike an account termination which is often triggered by the failure of a borrower to make payments when due, a credit limit reduction or suspension in advances generally involves an investigation and subsequent determination by the creditor of a decline in property value or a material change in the consumer's financial circumstances. Since this is not a snap decision, there is no sound reason why the creditor cannot provide simultaneous notice. The Board should require that written notice of a credit limit reduction or suspension in advances be delivered at the same time the action is taken, or if the notice is mailed, that it must be sent no later than 3 business days before the action is taken (so as to allow time for mail delivery). Because the consequences of a credit limit reduction or account suspension are severe, consumers should be afforded additional time to seek out alternatives. The additional time may also be used by consumers to investigate whether the proposed action is permissible and to pursue dispute or reinstatement procedures.

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[147] Proposed Regulation Z § 226.5b(c)(5).
[148] Proposed Official Staff Commentary § 226.5b(e)-4.
[149] Aubin v. Residential Funding Co., 565 F. Supp. 2d 392, 397 (D. Conn. 2008).

B. ***The Board Has Correctly Concluded That Guidance Is Needed on HELOC Terminations Based on the Consumer's Failure to Meet Repayment Terms, but the Proposed Thirty-Day Nonpayment Benchmark Is Not the Appropriate Timeframe***

Consistent with 15 U.S.C. § 1647(b)(2), current Regulation Z § 226.5b(f)(2)(ii) permits a creditor to terminate a HELOC and accelerate the account balance if the consumer has failed to "meet the repayment terms of the agreement for any outstanding balance." The current Commentary additionally provides that this provision applies "only if the consumer actually fails to make payments." The Board is proposing to clarify this further by providing that a HELOC account may not be terminated and the balance accelerated unless the borrower has failed to make the required minimum payment within 30 days of the due date.

To avoid having minor payment infractions be the basis for HELOC terminations, the Board is correct in providing additional clarification. However, the proposed 30-day period for nonpayment is not an appropriate timeframe for home secured loans. While HELOCS differ from other consumer mortgage products in many respects, the one critical feature that they share with all mortgages is that default can lead to foreclosure and loss of the consumer's home. A short 30-day period following a delinquent payment before a creditor can accelerate and demand payment of the full account balance is completely inconsistent with current loss mitigation conventions. Mortgage creditors and servicers typically make efforts to contact the borrower after the borrower is 30 days late. If some loss mitigation workout has not been reached within 60 to 90 days after the late payment, only then does the creditor send a notice of default. Under the typical Fannie Mae and Freddie Mac Uniform Mortgage Instrument, the notice of default gives the borrower another 30-day period to cure the mortgage default before the account can be accelerated.[150] Unlike the Board's proposal which could result in acceleration and initiation of foreclosure proceedings after a payment is only 30 days late, consumer borrowers for all other mortgages are typically given a period of 90 to 120 days to avoid foreclosure.

The short 30-day period is also not justified because there are other means to address creditor safety and soundness concerns for HELOCs. The Board's rules permit a creditor to protect its interest by temporarily suspending or reducing a HELOC account if the borrower has missed payments, rather than by terminating and accelerating the account. Account suspension protects the creditor's interest and provides an opportunity for the borrower to cure and seek reinstatement. The Board should require creditors to take this less drastic step, combined with advance notice of the termination and an opportunity for the borrower to cure the default, before an account can be accelerated.

The Board must not lose sight of the secured nature of these transactions. While some HELOCs may function like credit card accounts for consumers, they have the potential to result in the loss of the family home and therefore must include greater

[150] *See* Federal National Mortgage Ass'n/Federal Home Loan Mortgage Corp. (FNMA-FHLMC), Mortgage Documents Security Instruments, *available at* https://www.efanniemae.com/sf/formsdocs/documents/secinstruments.

consumer protections than other open-end accounts. It is worth noting that the recent Credit Card Act requires an account to be more than 60 days delinquent before an APR may be increased as a penalty rate on existing balances. Although the Board is correct that this provision deals only with the repricing of an account, it reflects Congressional intent in dealing with credit card abuses by creditors that 60 days is an appropriate delinquency threshold. Certainly home secured loans should not have a less demanding standard for determining when a creditor can initiate foreclosure proceedings.

The Board should revise the proposal to provide that a HELOC account may not be terminated and the balance accelerated unless the borrower has failed to make the required minimum payment within 60 days of the due date. Before the account may be terminated and after the 60-day delinquency period has passed, the creditor should be required to provide notice that the borrower can avoid account termination by bringing the account current within 30 days after the notice is sent. If the creditor elects to suspend or reduce the account during the cure period, the notice of credit limit reduction or suspension in advances must be included with the cure right notice.

C. *A Restriction on Imposition of Penalty Rates and Other Steps in Response to Late Payment Is Appropriate, but the Board's Language Should Be Much Clearer and the Period Should Be Sixty Rather Than Thirty Days*

The Board has stated in its Section-by-Section analysis that it is proposing to allow creditors to impose penalty rates only when a payment is 30 days late or more.[151] It identifies this restriction as being found in Proposed Regulation Z § 226.5b(f)(2), and states that it is discussed further in the Section-by-Section analysis relating to that section.[152]

However, we can find nothing in the Section-by-Section analysis of Proposed Regulation Z § 226.5b(f) that discusses a restriction on the imposition of penalty rates. Nor can we find any language in Proposed Regulation Z § 226.5b(f) that imposes such a restriction, even though Proposed Official Staff Commentary § 226.5b(f)(2)(ii)-1 refers to it.

Proposed Official Staff Commentary § 226.5b(f)(2)(ii)-1 states:

> Under this paragraph, a creditor may not terminate and accelerate a home-equity plan, or take the lesser actions of permanently suspending advances or reducing the credit limit, *imposing a penalty rate of interest,* or adding or increasing a fee … unless the consumer's required minimum payment is not received by the creditor within 30 days after the due date for that payment.

(Emphasis added).

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[151] 74 Fed. Reg. 43,428, 43,473 (Aug. 26, 2009).

[152] *See also* 74 Fed. Reg. 43,428, 43,515, 43,516 (Aug. 26, 2009) (similarly stating that the Board's proposal prohibits the imposition of a penalty rate unless the consumer is 30 days late or more).

By contrast, the language of Proposed Regulation Z § 226.5b(f)(2) is missing any reference to imposition of penalty rates:

> No creditor may, by contract or otherwise—
> (2) terminate a plan and demand payment of the entire outstanding balance in advance of the original term (except for reverse-mortgage transactions that are subject to paragraph (f)(4) of this section) unless—
> …
> (ii) the consumer fails to make a required minimum periodic payment within 30 days after the due date for that payment; …

The imposition of penalty rates may be governed by Proposed Regulation Z § 226.5b(f)(3)(i), which allows creditors to change the terms of HELOCs upon the occurrence of an event specified in the credit agreement. However, that section does not impose the requirement that the consumer be more than 30 days late.

The same questions arise with respect to permanent suspension or reduction of the credit limit and addition of a fee. Proposed Official Staff Commentary § 226.5b(f)(2)(ii)-1 states that these steps are allowed only if the consumer's payment is more than 30 days late, but Proposed Regulation Z § 226.5b(f)(2) does not mention these steps. Instead, a different section of the regulation—Proposed Regulation Z § 226.5b(f)(3)(vi)(C)—appears to allow these steps whenever the consumer "is in default of *any* material obligation under the agreement" (emphasis added)—with no mention of a requirement that the consumer be more than 30 days late.

We urge the Board to clarify Regulation Z to make it clear that the same prohibition on hair-trigger termination and acceleration of HELOCs applies to imposition of a penalty rate, permanent suspension or reduction of the consumer's credit line, and increases in fees. We also urge the Board to allow these steps only if the consumer's payment is more than 60 days late, rather than 30 days late. All of these steps have severe consequences. The imposition of a penalty rate or additional fees can lead to rapid depletion of the consumer's equity and ultimately to loss of the home. Allowing such a speedy permanent suspension or reduction in the consumer's credit line is completely unnecessary in light of the provisions for temporary suspensions or reductions.

D. *The Board's Safe Harbor Proposal for Suspensions and Credit Limit Reductions Based on a Property Value Decline Will Encourage Abusive Lending Practices*

The Board is proposing to retain the existing safe harbor standard for determining whether a decline in property value is significant for purposes of account suspensions and credit limit reductions, and add a second safe harbor for high combined loan-to-value (CLTV) HELOCs. For HELOCS with a CLTV at origination of 90% or higher, Proposed

Official Staff Commentary § 226.5b(f)(3)(v) would provide that a 5% reduction in the property value would be deemed a significant decline in value.

In the subprime mortgage market, HELOCs have been offered primarily as 80-20 financing deals. These are highly leveraged purchase or refinancing transactions, leaving little or no equity cushion at the time of origination. The HELOC is a line of credit in name only, as nearly the entire amount available is drawn down at closing. These 80-20 loans helped fuel the current foreclosure crisis, permitting transactions that if treated as a single loan would not comply with conventional LTV underwriting standards. The Department of the Treasury estimates that up to 50% of at-risk mortgages in the current foreclosure crisis have second liens.[153]

The Board's proposal in easing the termination rules based on property decline will encourage lenders to continue making 80-20 or similar loans with harmful consequences for borrowers. In anything other than a rapidly escalating real estate market, a creditor can easily contend that there has been a 5% reduction in property value. The Board's proposal would permit creditor's to market and make high CLTV HELOCs with little downside, knowing that they can suspend use of the credit line immediately after the loan is originated. The Board's rule will be easily manipulated by predatory lenders seeking to lure borrowers into abusive transactions.

The Board's proposal also fails to recognize the true nature of a high LTV loan. A lender making a mortgage with a CLTV at origination of 90% or higher is essentially granting unsecured credit. Lenders who make high LTV loans take their illusory security in the borrower's home not for its economic value or the ability to foreclose, but for the threat of foreclosure. This has long been recognized by regulators.[154] Lenders therefore should be held to the original bargain and not permitted to suspend credit lines based on a decline in value that is only slightly less that the value of the property at origination.

The statutory authority for creditor action based on a property value reduction is premised on the rational underwriting principal that the mortgage loan is in fact secured at origination and that there is an equity cushion. In permitting account suspensions and credit reductions when the value of the home securing the HELOC is significantly less than the value of the property at origination, Congress intended that a creditor could take appropriate action after origination to preserve and prevent further erosion of this equity cushion. If there is no real equity cushion at origination, as is the case with high CLTV HELOCs, creditors should not be permitted to invoke the statutory provision. An account suspension or credit limit reduction based on a property value decline, when property

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[153] *See* Dep't of Treasury Making Home Affordable Program Update (Apr. 29, 2009).

[154] In 1998, the Office of Thrift Supervision stated:

> When the combined LTV exceeds 90 percent, however, the proceeds from the sale of the security property will likely not be sufficient to fully liquidate the home equity loan and any outstanding senior liens. The portion of such loans that exceeds 100% of value is effectively unsecured, so lenders are likely to suffer a complete loss if they make a mistake in assessing a borrower's credit and the borrower subsequently defaults .... High LTV lenders state that they recognize that these loans are more or less unsecured, and it is not likely they will benefit from foreclosure.

Office of Thrift Supervision, Department of the Treasury, Thrift Bulletin TB 72, at 2 (Aug. 27, 1998).

value was not a risk factor considered by creditor at the time the loan was made, is an unfair and deceptive practice. Thus, we urge the Board to invoke its UDAP authority and prohibit limitations on high CLTV HELOCs, including account suspensions and credit limit reductions, based solely upon a decline in property value.

Additionally, the proposed safe harbor rule for high CLTV HELOCs is inconsistent with the statutory language. The statute permits suspension of advances or reduction of credit limits only if the value of the home securing the HELOC "is significantly less" than the value of the property at origination.[155] The term "significantly" suggests that the change must be of a noticeably or measurably large amount. In selecting this statutory language, it in inconceivable that Congress intended for a credit line suspension or reduction to be triggered by a nominal 5% reduction in value that is only slightly less that the value of the property at origination. For example, if a creditor grants a HELOC with a $25,000 credit line on a home valued at $150,000 that is subject to a $120,000 senior mortgage, the creditor should not be permitted to cut off the borrower's credit line when there has been a mere $7,500 decline in the home's value as under the proposed rule.

If the Board does not ban high CLTV HELOC limitations based on property value decline, a more fair approach that gives the borrower the benefit of the original bargain would be a rule that prohibits a suspension of advances on the line until the property value declines by at least the full amount of the original credit line. In the above example, a suspension could not occur until the property would decline by at least $25,000. Alternatively, if the Board retains a flat percentage property value decline for CLTV HELOCs, it should be set at an amount that is more consistent with the statutory language, such as a 15 to 20% decline in value.

E. *The Proposal Permitting Creditors to Require the Consumer to Request Reinstatement Should Be Rejected*

The Board should be commended for clarifying in Proposed Regulation Z § 226.5b(g) that credit line suspensions must be temporary and that creditors have an obligation to restore advance privileges once the action giving rise to the suspension no longer exists. However, the Board should not give creditors the option to require that consumers must request reinstatement.

Under Proposed Regulation Z § 226.5b(g)(1), creditors have two options. They may monitor the line on an ongoing basis to determine if the condition permitting a freeze or reduction continues to exist. Alternatively, they may elect to require the consumer to make an affirmative request for reinstatement. The Board should not permit an election. Creditors should have an ongoing obligation to monitor HELOCs and borrowers should have the right to request reinstatement.

Particularly with respect to line suspensions based on a change in the borrower's financial circumstances, ongoing monitoring in all cases should be required. If the

[155] 15 U.S.C. § 1647(c)(2)(B).

account is active, this requirement is not burdensome because the creditor is likely obtaining periodic updates of the borrower's credit status. The Board's proposed rule would permit the creditor to sit on positive information it has obtained and simply wait until the borrower requests reinstatement, even if that information would demonstrate that the condition compelling suspension has abated.

Similarly, in a real estate market in which there have been steady property value increases, creditors with ready access to publically available data showing such a trend should be required to reevaluate credit line suspensions that were based on a property value decline rather than wait for a borrower request. Most HELOC creditors make use of easily accessible online Automated Valuation Model (AVM) appraisal tools. Once again, this is information that HELOC creditors and servicers are constantly monitoring for a variety of purposes and should therefore not be burdensome.

F. ***The Proposal to Impose Creditor Obligations When a Borrower Requests Reinstatement Will Be a Significant Improvement, but the Borrower Should Not Need to Request Property Value Information***

Proposed Regulation Z § 226.5b(g)(2)(i) provides that if the creditor requires the consumer to request reinstatement, the creditor must disclose the requirement. As mentioned above, we oppose giving creditors the option to impose this requirement as the exclusive method for obtaining reinstatement and urge the Board to require creditors to engage in ongoing monitoring. However, we support disclosure of the reinstatement right. All notices of suspension or credit line reduction should contain information about the borrower's right to request reinstatement and the reinvestigation procedure. We also support the requirement that the investigation on a request for reinstatement should be concluded and written notice of the results mailed within 30 days of the request.

Proposed Regulation Z § 226.5b(g)(2)(v) requires notification of the investigation results only if the results show that reinstatement will not be granted. The Board's proposal may permit evasion in the situation in which account privileges may be reinstated but not on the original terms. If the rule can be interpreted as not requiring notice under those circumstances, borrowers will be denied notice of specific reasons why they were not granted full reinstatement. For this reason, the Board should require notice of investigation results in all cases even if the account is reinstated.

The Board has also proposed that no fee may be charged to the borrower for the investigation following the first request for reinstatement. This would permit the creditor to charge fees for investigation after the one free reinstatement request. We believe that there should be an appropriate time period after which the right to request investigation free of charge shall be restored. For example, if a period of 6 months has passed after the borrower has received notice that the first free reinstatement request has been denied, the borrower should be permitted to make another request without being imposed investigation charges. In addition, if the creditor imposes charges for subsequent requests after the free reinstatement request, the creditor should be required to creditor to describe and itemize the fees in the reinstatement denial notice sent to the borrower.

Proposed Regulation Z § 226.5b(g)(2) would require a creditor to provide a copy of the documentation supporting the property value it relied upon in freezing or reducing a credit line, but only if the consumer makes an affirmative request for the documentation. We support the Board's proposal to make this information available to consumers. However, we believe that the consumer should not have to request the information.

Because a credit line suspension or reduction can have a severe impact on consumers, they should be provided a copy of the valuation report when notified of the creditor's initial action or reinstatement request decision. As the Board has recognized, HELOC creditors rarely base the decision to freeze or reduce a credit line on a full appraisal or even a BPO, but instead commonly rely upon software-based Automated Valuation Models (AVM) appraisal models. Most consumers are unaware of AVM appraisal models and do not understand how they operate. They are likely to believe that creditors have performed a more traditional full property appraisal rather than an AVM valuation review, and therefore will be less inclined to make a request for a copy of the report. Consumers are also not likely to be aware of accuracy concerns about such valuation methods based on the use of outdated historical data when considering whether to request a copy of the report. Moreover, requiring that a copy of the report be provided in all instances would not be burdensome because of the industry reliance on online AVM model reports which can be easily produced.

If the Board persists in requiring consumers to make an affirmative request for a copy of the report, then the Board should require that if the property valuation is based on an AVM model, then the creditor must be required to provide an explanation of the AVM valuation method and specifically disclose all of the factors considered in the model. Known limitations with such models, such as the failure to consider the location of the subject property or any recent improvements to the property, should be disclosed. The creditor should be required to disclose how often the historical data is updated and when the data relied upon for the report was last updated.

G. *The Board Should Mandate a Dispute Procedure for HELOCs*

The Board has proposed rules dealing with HELOC terminations and suspensions based on various objective and subjective factors, from property values to consumers' financial condition. As such, the application of these rules will inevitably result in improper determinations made by servicers on behalf of creditors due to errors and incomplete information. Normally, if a consumer believes that a servicer has made an account error, the consumer can request information about the servicer action and can dispute the error by sending a qualified written request under RESPA.[156] Regrettably, HUD has construed the RESPA Servicer Act provisions in Regulation X so as not to apply to HELOCs covered by the Truth in Lending Act and Regulation Z.[157] Although

[156] *See* 12 U.S.C. § 2650(e).

[157] Regulation X states that the Servicer Act provisions apply to a "mortgage servicing loan," which includes all "federally related mortgage loans…when the loan is secured by a first lien," but does not

RESPA was amended in 1992 to include loans secured by subordinate liens, HUD has not changed its position with respect to HELOCs.[158]

HUD apparently decided to exempt HELOCs because of its view that HELOCs were the subject of "extensive disclosure materials already issued under Regulation Z," and that the "disclosure materials were extensive and there had been recent thorough congressional oversight and action (Home Equity Loan Consumer Protection Act of 1988, 15 U.S.C. 1647, Pub. L. No. 100-709)."[159] HUD's position is based on the false premise that TILA contains regulation comparable to the RESPA Servicer Act provisions. While there is overlap between RESPA and TILA on loan origination disclosures, the TILA regulatory regime does not include dispute and information disclosure requirements for open-end mortgage loans other than the limited billing error rights available under the Fair Credit Billing Act. We urge the Board to either adopt an information disclosure and dispute procedure for HELOCs[160] or encourage HUD to delete the HELOC exception from Regulation X with respect to the RESPA Servicer Act provisions.

H. *The Board's Proposal for Limiting Denied Advance and Over-the-Limit Fees Is an Improvement but Needs an Important Clarification*

Proposed Regulation Z § 226.9(j)(2) provides that a creditor that reduces the credit limit on an account may not charge the consumer fees for exceeding the limit until after the consumer has received notice of the action. This helpful provision recognizes that consumers should not be charged denied-advance and over-the-limit fees without being given advance notice of the creditor action and the opportunity to avoid the charges. However, the proposal should include additional clarification that no over-the-limit fees may be charged, even after advance notice, when a credit limit is reduced below the current account balance at the time the action is taken, provided that such balance remains below the pre-change credit limit. For example, if the account's credit limit is set at $25,000 and the borrower's balance is $22,500 at the time the creditor provides notice of a credit limit reduction to $20,000, the Board should make clear that the consumer cannot be charged an over-the-limit fee based solely on the over limit status caused by the credit limit reduction, irrespective of whether notice is provided. The consumer in this example has kept the account below the credit limit before the creditor's unilateral action and does not have the opportunity to avoid the fees through a prospective change in usage of the account, other than by making a substantial lump-sum principal reduction payment. Borrowers unable to make such a principal payment should not be penalized in this situation based on the creditor's change in terms.

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include "subordinate lien loans or open-end lines of credit (home equity plans) covered by the Truth in Lending Act and Regulation Z, including open-end liens of credit secured by a first lien." Regulation X, 24 C.F.R. § 3500.21(a).

[158] At least one court had held that the exemption for subordinate lien loans in Regulation X is not entitled to deference because it clearly conflicts with the statute. *See* Cortez v. Keystone Bank, 2000 U.S. Dist. LEXIS 5705 (E.D. Pa. May 2, 2000).

[159] *See* 59 Fed. Reg. 6506, 6511 (Feb. 10, 1994).

[160] This could be accomplished with minimal effort by requiring creditors to apply the RESPA Servicer Act to HELOCs regardless of HUD's interpretation.

V. FORCED PLACE INSURANCE—PROPOSED § 226.20

The Board requests comments on whether creditor-placed insurance requires the same regulation when written in conjunction with a HELOC as it does when written in conjunction with an automotive or closed-end home mortgage loan. The same market dysfunctions and perverse incentives exist for creditor-placed insurance, irrespective of the type of loan or collateral. That HELOCs give consumers the option to obtain additional credit does not change the fact that, for an existing loan, the same abuses can occur, whether the existing mortgage loan was obtained through a closed-end or an open-end plan. While certain subsections of 15 U.S.C. § 1639 do not apply to HELOCs, subsection 1639(*l*)(2) defines its scope as "mortgage loans," which clearly includes HELOCs. Thus the same recommendations as to proscribing unfair and deceptive practices apply to HELOCs as to closed-end mortgage loans. For a more comprehensive discussion of this issue, we refer to the Board to Section IX of our comments on the Board's closed-end proposal.[161]

CONCLUSION

As explained in these comments, we are deeply concerned that the proposed HELOC regulations will expose consumers to even more predatory lending than the public has already experienced. The weak disclosure requirements and the tremendous gap between what the Board proposes to require for closed-end credit and open-end credit will make HELOCs an attractive market for deception and unfair lending practices. While the Board's proposal includes some improvements, we urge the Board to revisit its disastrous overall approach to HELOC regulation.

[161] Attached as Appendix I to these comments.

APPENDIX I

NCLC and Others' Comments on Boards's Closed End Proposal (Reg. Z; Docket No. R-1366)

COMMENTS
to the
Federal Reserve Board

12 C.F.R. Part 226
[Regulation Z; Docket No. R-1366]
Truth in Lending—Proposed Rule

by the National Consumer Law Center[1]
(on behalf of its low-income clients)
and for
the National Association of Consumer Advocates,
Consumer Federation of America
Consumer Action
the National Fair Housing Alliance
and **the Center for Responsible Lending**

December 24, 2009

The National Consumer Law Center (NCLC) submits the following comments on behalf of its low-income clients, as well as the National Association of Consumer Advocates, Consumer Federation of America, Consumer Action, the National Fair Housing Alliance, and the Center for Responsible Lending, to the Federal Reserve Board regarding the proposed rule resulting from the Board's comprehensive review of the Truth in Lending Act's (TILA) rules for closed end credit.

[1] These comments were written by NCLC attorneys Carolyn Carter, Alys Cohen, Andrew Pizor, Leah Plunkett, John Rao, Margot Saunders, Jon Sheldon, and Diane E. Thompson. Please note that NCLC has also submitted comments on the proposed rule regarding open end home secured credit or home equity lines of credit (HELOCs) under docket number R-1367. Because there is some overlap between the proposals for closed-end credit and HELOCs, as well as in our discussion of them, we have included a copy of our HELOC comments as Appendix I. for ease of reference. For each section, we have also identified the section in our HELOC comments which discusses the same or a similar topic.

ABOUT THE ORGANIZATIONS COMMENTING

The **National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (6th ed. 2007), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (4th ed. 2009), and *Foreclosures* (2d ed. 2007), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to address predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws.

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

Consumer Action (www.consumer-action.org) is a national non-profit education and advocacy organization that has served consumers since 1971. Consumer Action serves consumers nationwide by advancing consumer rights in the fields of credit, banking, housing, privacy, insurance and utilities. Consumer Action offers many free services to consumers and communities, including an assistance/referral hotline. Consumer Action also develops free consumer education modules, training, and multi-lingual materials for its network of more than 8,000 community based organizations. Consumer Action's publications are offered in Chinese, English, Korean, Spanish and Vietnamese.

Consumer Federation of America (CFA) is a nonprofit association of some 300 national, state, and local pro-consumer organizations created in 1968 to represent the consumer interest through research, advocacy, and education.

The National Fair Housing Alliance is a consortium of more than 220 private, non-profit fair housing organizations, state and local civil rights agencies, and individuals from throughout the United States. Headquartered in Washington, D.C., the National Fair Housing Alliance, through comprehensive education, advocacy and enforcement programs, provides equal access to apartments, houses, mortgage loans and insurance policies for all residents of the nation.

The Center for Responsible Lending is a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

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I. OVERVIEW OF BOARD'S PROPOSED CHANGES[2]

Recent developments have made clear the imperative for significantly increased substantive regulation of home mortgaged other forms of closed end credit. We strongly support the Board's efforts to revise disclosures and add protections for home mortgages. We also hope that the Board will recognize that there are several important protections the Board must still mandate. These comments will provide detailed support for these specific proposals, as well as offer suggestions on how to make the Board's proposed substantive and disclosure provisions more effective.

We applaud the Board's use of its authority to prohibit unfair and deceptive practices,[3] in these proposed regulations including:

- Restrictions on yield spread premiums;
- Prohibitions on consumer and lender payments to originators; and
- Prohibitions on steering borrowers into loans which are not in their interest. [4]

These consumer protections proposed by the Board will address serious problems in the mortgage marketplace. In section XI, we discuss some refinements to ensure the goals behind these significant proposals are fully realized.

The large majority of the Board proposals involve new disclosure requirements which we also strongly support. Many of the changes to the proposed disclosure regime will make the TILA disclosures considerably more meaningful, including:

- *All-In Finance Charge*. Including almost all credit related charges in the finance charge for home secured transactions is a major improvement, which will make the TILA disclosures more relevant and helpful to consumers.
- *Requiring Disclosures of Adjustable Rate Mortgages Based on Maximum Possible Payments,* instead of a fictitious fully indexed rate.
- *Improved Disclosure Format for Adjustable Rate Mortgages (ARMs)*, in tabular form, will assist consumers in comparing the costs and risks for complex ARMs.
- *Improved Timing and Substance of Disclosures,* involving a myriad of improvements to initial, early and final disclosures, replacing the CHARM booklet, and mandating disclosures be non-changeable seven days before closing all contribute to making TILA disclosures much more meaningful and helpful.

We commend the Board in its use of consumer testing and a more scientific approach to designing effective disclosure forms. For example, we especially favor ending multi-purpose forms for mortgage disclosures. More targeted disclosures should

[2] An overview of the Board's HELOC proposal and its limitations is set forth at Section I of our HELOC comments, reprinted at Appendix I, *infra*.
[3] 15 U.S.C. § 1639(l)(2)(A).
[4] See further comments supporting the Board's proposals on these points at Section XI, *infra.*

improve clarity by eliminating irrelevant information. We also support the proposal to require the APR to be disclosed in a very prominent 16-point font.

Despite these important improvements to the required disclosures, there is a real need for more substantive regulation of mortgage loans under the Board's unfairness authority. Certain current practices are so unfair that mere disclosure of their nature will not be enough. For example, we propose at §§ II.E and II.F that the Board prohibit negative amortization and payment option ARMs in home mortgage transactions. In the absence of such a prohibition, we support (with a number of suggested changes) additional proposed disclosures for ARM transactions. But we believe that, ultimately, any disclosure scheme for negative amortization or payment option ARMs will be inadequate, and that an outright ban of these features is the only way to prevent unfair and deceptive practices.

Section II outlines the need for more substantive regulation under the Board's unfairness authority, in four specific areas.

- Negative Amortization and payment option ARMS;
- The application of the ability to repay standard to all home loans;
- The underwriting of all home loans based upon the maximum possible payment; and
- The initiation of foreclosures where HAMP loan modification analysis and procedure have not been completed.

Section II also examines the special problems with payment option ARMs, and other abuses in the current mortgage market, and explains why a disclosure regime is inadequate to protect consumers from these abuses. Instead, substantive regulation under the Board's unfairness authority is required. Additional areas where use of the unfairness authority is required in lieu of disclosures are detailed throughout these comments.

Sections III, IV, and V are generally supportive of the Board's new definition of finance charge. Additional suggestions particularly deal with the treatment of credit insurance, both as to disclosures and use of the unfairness authority to outlaw no-benefit credit insurance. We also make suggestions for extending the Board's inclusive approach to finance charges.

Section VI focuses on the early disclosure proposals. In general, we support the provisions, but believe that any waiver of these provisions must be extremely narrow to avoid eviscerating the purpose of the early disclosure requirements. In addition, we offer additional proposals to make early disclosures more effective.

Section VII focuses on early disclosures for ARM loans. While we believe that payment option ARMs should be prohibited in consumer mortgage transactions, we offer comments on the disclosure provision in case the Board does not act on that recommendation. We offer recommendations as to the scope of the ARM early disclosures, use of the CHARM booklet, and the content and format of the disclosures.

Section VIII treats the Board's proposals as to subsequent disclosures. While we are generally supportive, we believe the proposed disclosures need revision and additional information should be disclosed.

Section IX examines the disclosure proposal for creditor-placed property insurance. We set out certain market dysfunctions in the sale of this form of insurance and urge use of the Board's unfairness authority to correct abuses. In particular, we believe that where servicers make voluntary insurance payments from the consumer's escrow account, it is unfair for the servicer to ever force-place insurance where voluntary insurance is better alternative for both the consumer and creditor. We are also critical of the limited nature of the disclosure provision.

Section X examines the proposed changes to the HOEPA Rule. Again, we support much of the change, but recommend additional revisions.

Section XI focuses on the important provisions dealing with yield spread premiums and steering. We strongly support the use of the unfairness authority to prohibit these abuses, but have a number of specific recommendations for making these provisions more effective.

Finally Section XII details the numerous changes to closed-end disclosures. We view the revision as a significant improvement but certain corrections are needed. Our comments go both to content and format of the disclosures, and also focus on the computation of certain of the required information.

II. CRITICAL SUBSTANTIVE PROVISIONS NOT ADDRESSED IN THE BOARD'S PROPOSAL[5]

A. *Introduction: "The Board, by regulation or order, shall prohibit acts or practices in connection with . . . mortgage loans that the Board finds to be unfair [or] deceptive."*[6]

> *Freedom is the right to be wrong, not the right to do wrong.*
> John G. Diffenbaker (1895-1979), Canadian prime minister

We believe the Board's proposal fails to sufficiently comply with Congress's instructions to identify and make illegal unfair and deceptive practices in the mortgage industry. This mandate is not couched as discretionary—the statute does *not* say "the Board *may* prohibit." Congress deliberately gave to the Federal Reserve Board the *order* to prohibit unfair and deceptive acts in the mortgage industry.

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[5] An overview of the Board's HELOC proposal and its limitations is set forth at Section I of our HELOC comments, reprinted at Appendix I, *infra*.

[6] 15 U.S.C. § 1639(*l*)(2)

Yet, now—when the mortgage industry is in a complete shambles and it is commonly recognized that the lack of applicable regulation has caused this crisis—the Board still has not fully implemented this authority. There is no doubt that the disclosure regime for closed-end credit needs vast improvement, and that the Board's proposals for changing the required TIL disclosures will considerably improve that regime. However, *disclosures will not protect consumers from the blatant and continued unfair and deceptive practices in the industry.*

The Board is required to go much further than it has to date. The Board is required to prohibit unfair acts and practices—and there are several critical unfair practices in the mortgage marketplace that the Board's proposal fails to address. While some of these areas, such as creditor-placed credit insurance and credit insurance, will be examined throughout these comments, four of the most significant areas are examined in this section.

B. *The Need for the Board to More Aggressively Ban Unfair Practices in the Mortgage Market*

1. Introduction

Mortgage delinquencies and foreclosures are at extraordinarily high levels.[7] Mortgage originations have plummeted to historic lows—issuance of non-prime mortgage securities virtually ceased by the end of 2008—and analysts do not expect it to rebuild anytime soon.[8]

The current mortgage market is broken. One out of twelve of all mortgages in the United States is seriously delinquent; one out of ten is past due.[9] While some of the delinquencies and foreclosures are undoubtedly caused by the recession, a huge chunk of the problems in the mortgage market is caused by the tens of thousands of risky, un-payable, and completely impenetrable adjustable rate mortgages made in both the prime and subprime markets. The delinquency statistics are proof of this.

2. The Special Problem of ARMs

If the economy alone were the primary cause of delinquencies, then the delinquency statistics for the different types of loans would likely be fairly similar—indeed, given the today's low interest rates, ARM loans would be more likely to have lower delinquency figures than fixed rate mortgages. But in fact the opposite is true—the delinquency statistics for adjustable rate loans far exceed those for fixed rate loans:

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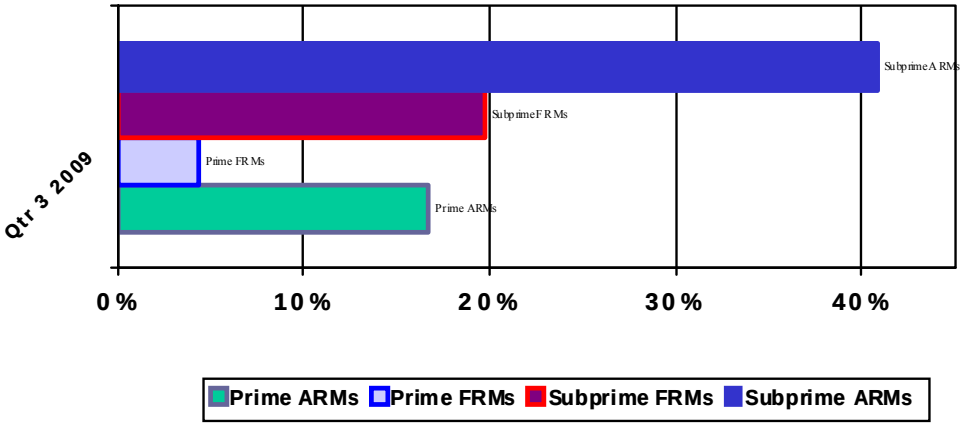
[7] National Delinquency Survey from the Mortgage Bankers Association, Third Quarter, 2009, at 2. The Mortgage Banker's Association reports the percentage of loans seriously delinquent each quarter in its Delinquency Survey. Seriously delinquent includes the loans that are at least 90 days delinquent plus the loans in foreclosure inventory.

[8] *Inside B&C Lending* (February 27, 2009).

[9] National Delinquency Survey from the Mortgage Bankers Association, Third Quarter, 2009, at 4.

Table 1[10]



In this era of historic low interest rates,[11] if the adjustable rate loans were truly adjustable—in other words the interest would decrease as well as increase—and had been properly underwritten to determine affordability, the delinquency figures for the adjustable rate loans should be at much lower rates than those for the fixed rate loans. This is because, if the payments for the adjustable rate loans had decreased along with the indices to which their payments are tied, the payments for these loans would be lower than their fixed rate counterparts, and the delinquencies would be fewer.

The fact that delinquencies for adjustable rate loans are higher in these times of historically *low* interest rates is an illustration that these loans were seriously flawed at the outset:

- The interest rates only went *up* from the initial rate,[12] meaning that the borrower took all of the risk from the adjustable interest rates, yet could reap none of the potential benefits from adjustments;
- There was inadequate underwriting to determine the borrower's ability to repay the loan, and even the initial payments were not affordable to the homeowner, or
- If the loan was a payment option ARM, there was typically no evaluation of the borrower's ability to pay the swollen payments required after the reset.[13]

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[10] Table 1 data derived from National Delinquency Survey from the Mortgage Bankers Association, Third Quarter, 2009.

[11] The six month LIBOR rate for December 16, 2009 is 0.45, an all time historic low point. BankRate.com; http://www.bankrate.com/rates/interest-rates/libor.aspx?ec_id=goog_ag_libor_goog_brm_ky_b_k_current_libor.

[12] It is a standard term of subprime hybrid ARM loans—2/28s and 3/27s—that the interest rates can only increase from the initial rate, never decrease.

[13] Even the 2006 "guidance" issued by the five federal banking regulators to deal with the risks of these loans did not require underwriting for actual payments that would be required after the payments reset; only requiring an analysis of the borrower's ability to make payments on a fully amortizing loan at the fully indexed rate—payments that are far lower than will ever actually be owed if the borrower makes the Initial payments even for only the first year. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

3. Inadequate Efforts to Limit the Number of Foreclosures

As icing on this disastrous cake, the government's efforts through the Home Affordable Modification Program (HAMP), to slow foreclosures and encourage loan modifications where both the investor and the homeowner would be better off is a complete failure. After operating for almost a year, only 31,382 mortgages have been permanently modified.[14] Foreclosures continue to escalate across the nation at an extraordinary pace.[15] Many, many of these foreclosures are *less advantageous to the investor* than the loan modification that the homeowner is ready and able to agree to.[16]

This is an absurd situation for this nation to be in—escalating foreclosures, which cost homeowners, investors, neighbors, and local governments, millions of dollars—even when many of these foreclosures could be avoided. The Federal Reserve Board has the power and the ability to change this situation: simply by passing a rule under its unfairness authority prohibiting the initiation of a foreclosure without the HAMP analysis.

4. Four Critical Areas Requiring Utilization of Unfairness Authority

All of these are indications of unfairness in the mortgage marketplace—unfairness which the Board is *required* to identify and prohibit. The Board cannot be concerned just with preserving access to credit,[17] but must ensure that the credit that is accessed by consumers—especially when it is secured by homes—must not be toxic.

Congress's mandate to the Board to prohibit unfair practices in the mortgage market, requires that the Board:

1. Ban payment option ARM loans for all loans secured by the borrower's principal residence. *See* §§ II.D, II, E, *infra.*

2. Extend the requirements currently applicable only to higher cost loans[18] regarding the determination of the borrower's ability to repay, to *all* mortgage loans secured by a borrower's principal residence. *See* § II.F, *infra.*

3. Require underwriting for all adjustable rate loans which determines the borrower's ability to repay the highest possible payments that may be required under the loan terms (counting both alternative amortization terms and the highest permissible interest rates). *See* § II.G, *infra.*

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[14] Making Home Affordable Program, Servicer Performance Report Through November, 2009.
[15] National Delinquency Survey from the Mortgage Bankers Association, Third Quarter, 2009, at 2.
[16] *See, e.g.,* California Reinvestment Coalition, The Ongoing Chasm Between Words and Deeds: Abusive Practices Continue to Harm Families and Communities in California (2009); Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. Times, June 29, 2009.
[17] *See, e.g., Lending Squeeze Drags On*, Wall Street Journal, Dec. 9, 2009.
[18] Regulation Z § 226.35.

4. Prohibit the initiation of a foreclosure unless the HAMP loan modification analysis and procedure have been completed. *See* § II.H, *infra.*

Other areas requiring more than just an improved disclosure regime, but utilization of the Board's unfairness authority are detailed throughout this Comment.

The Board has already exercised its authority to address unfair and deceptive mortgage practices in its 2008 Final Regulations. These regulations recognized that the mortgage market does not have sufficient built-in incentives to ensure that lenders evaluate the borrowers' ability to repay their mortgage loans and to charge prepayment penalties only in fair circumstances. Yet, the Board provided the significant protections (of requiring meaningful underwriting for the ability to pay, prohibiting prepayment penalties in certain situations, and requiring escrow accounts) only for certain higher cost loans—not to the entire mortgage market.

The Board understands that the mortgage market needs substantive regulation. Now, at the end of 2009, when the delinquency rate for *prime* ARM loans exceeds 16%—more than 1 out of every 6 prime ARM loans is seriously delinquent—there is no reasonable basis for the Board to not extend the ability to repay underwriting protections to the entire mortgage market, to require appropriate underwriting for all loans, ban payment option ARM loans, and require loan modification analyses before foreclosures can be initiated.

C. *Disclosures Are Insufficient to Protect Consumers from the Dangers of Certain Loan Products and Terms*

1. Market Dysfunctions Limit the Effectiveness of Disclosures

No amount of disclosures can adequately protect the American public from the failure of underwriting the basic affordability of loans that is the quintessential feature of the most of the subprime market, and much of the prime market during the last decade. Premising protection of consumers almost entirely on disclosures assumes: that the credit market functions; that pricing is or can be made transparent to borrowers; that borrowers do not face duress when making borrowing decisions; and that borrowers are able to exercise sufficient influence over the terms of lending transactions to constrain creditors' behavior.

In fact, due to market segmentation (the splitting of the market into prime, subprime, and predatory), steering, and information asymmetries,[19] credit markets often

[19] Cassandra Jones Havard, *Democratizing Credit: Examining the Structural Inequities of Subprime Lending*, 56 Syracuse L. Rev. 233 (2006) (discussing market segmentation and information asymmetries); Elvin K. Wyly, Mona Atia, Holly Foxcroft, Daniel J. Hamme, Kelly Phillips-Watts, *American Home: Predatory Mortgage Capital and Neighbourhood Spaces of Race and Class Exploitation in the United States*, 88 Geografiska Annaler, Series B: Human Geography 105 (2006) (arguing that lenders have targeted vulnerable neighborhoods); Ronald J. Mann, *"Contracting" for Credit*, 104 Mich. L. Rev. 899, 914–915 (2005–2006) (describing how complexity, segmentation, and unilateral modification of terms combine to prevent increased consumer sophistication from reducing profits or increasing market

do not function. Pricing is often disconnected from actual risk. The credit offered a borrower may have as much or more to do with where the borrower lives than any objective assessment of the borrower's likelihood of repaying that credit. Some high-cost lenders exhibit reverse competition, charging higher pricing when there is more "competition."[20] Pure reliance on the principle of *caveat emptor* is an inappropriate solution, too, for at its core its message to consumers is: "assume that all business people are out to cheat you until proven otherwise."

For a borrower's contractual "choice" to have any meaning, borrowers must be able to evaluate the risks and benefits of the credit offered. Borrowers must also have meaningful alternatives to the credit presented. Neither of these premises describes the reality for many people.[21] The fiction of informed choice often collapses entirely for especially vulnerable consumers—the illiterate, the uneducated, frail older consumers, and those for whom English is a second language. Many borrowers, but particularly African Americans and Latinos, have a misplaced faith that lenders will—indeed are required to—provide the best rates.[22] Worse, abusive sellers and lenders frequently target borrowers who are perceived as vulnerable, including members of racial groups

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efficiency); Ronald H. Silverman, *Toward Curing Predatory Lending,* 122 Banking L.J. 483, 531–544 (2005) (discussing information asymmetries, rent seeking, lack of competition, and adverse selection in predatory home mortgage lending); Michelle A. Danis & Anthony Pennington-Cross, The Delinquency of Subprime Mortgages 7 (Fed. Res. Bank St. Louis, Working Paper 2005-022A Mar. 2005) (discussing economic theories to explain market segmentation between prime and subprime), *available at* http://research.stlouisfed.org/wp/2005/2005-022.pdf; Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255, 1271–1283 (2002).

[20] *See, e.g.,* Robert DeYoung & Ronnie J. Phillips, Federal Reserve Bank of Chicago, Strategic Pricing of Payday Loans: Evidence from Colorado, 2000–2005, at 20, 22 (July 14, 2006), *available at* www.chicagofed.org/cedric/2007_res_con_papers/car_48_deyoungphillips_fedcommaffairsconf_715_preliminary.pdf (finding, in preliminary results, higher prices for payday lending higher in markets more thoroughly saturated by payday lenders).

[21] *See* Till v. SCS Credit Corp., 541 U.S. 465, 124 S. Ct. 1951, 1962–1964, 158 L. Ed. 2d 787 (2004) (recognizing that the subprime auto finance market is not "perfectly" competitive and that creditors have much more information about the market than do consumers); Richard Lord, American Nightmare: Predatory Lending and the Foreclosure of the American Dream (Common Courage Press 2005); Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 Harv. J. on Legis. 123, 139–149 (2007) (discussing lack of price transparency); Elizabeth Renuart, *An Overview of the Predatory Lending Process*, 15 Housing Pol'y Debate 467 (2004); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255 (2002). *Cf.* Sumit Agarwal, John C. Driscoll, Xavier Gabaix, & David Laibson, The Age of Reason: Financial Decisions Over the Lifecycle 37 (Feb. 11, 2008), *available at* http://ssrn.com/abstract=973790 (finding that older and younger borrowers pay more for credit than midlife borrowers across a range of credit products, perhaps because older and younger borrowers do not understand "shrouded attributes," such as the relationship between higher LTVs and higher APRs).

[22] Mortgage Foreclosure Filings in Pennsylvania: A Study by The Reinvestment Fund for the Pennsylvania Department of Banking 74 (Mar. 2005), *available at* www.trfund.com/policy/pa_foreclosures.htm, *citing* Fannie Mae's 2002 National Housing Survey. *Cf.* Martinez v. Freedom Mortgage Team, Inc., 527 F. Supp. 2d 827 (N.D. Ill. 2007) (Hispanic borrower's belief that broker would not arrange and lender would not originate loan he could not afford was reasonable); 74 Fed. Reg. 44,522, 44,542 (July 30, 2008) ("Borrowers could reasonably infer from a lender's approval of their applications that the lender had appropriately determined that they would be ale to repay their loans."); *id.* at 44,564–44,565 (discussing consumer testing showing that many consumers believe that brokers are "obliged to find them the lowest interest rates and best terms available").

historically excluded from mainstream credit, on the belief that the borrowers are, in some sense, still a captive market.[23] And borrowers who are a captive market are charged more.[24]

2. Disclosures Are Insufficient to Respond to Abuses in Complex Transactions

Borrowers do not have equal understanding or experience with credit as creditors do. And borrowers are at a further disadvantage when they confront the written materials creditors offer up. Most credit contracts are written in language far beyond what the average American can read and understand. The Government Accountability Office, as part of its study of credit cards, retained a usability expert to review credit card agreements and disclosures. The expert retained by the GAO found that credit card agreements required reading at a 15th grade level—or three years of college. By comparison, nearly half of American consumers read at no more than an 8th grade level. Unsurprisingly, then, most credit card *solicitations* are written at an 8th grade level.[25] Disclosures, perhaps because of federal laws requiring streamlined and standardized disclosures, are more readable than agreements, but less readable than solicitations, and generally require a 10th to 12th grade reading level.[26]

The mortgage products seen in the marketplace of the past decade often include terms and pricing which are so complex that they can puzzle economics professors.[27] At the same time, even the simplest of credit calculations evades many consumers. Roughly 40% of the U.S. population lacks the literacy to fill out correctly job applications or a

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[23] *See, e.g.*, Carlisle v. Whirlpool Fin. Nat'l Bank, Civil Action No. CV 97-068, Clearinghouse No. 52,516 (Circuit Court, Hale County Ala. Aug. 25, 1999) (finding defendants behavior "alarming" and "reprehensible," based on sales practices of targeting and take advantage of the poor, under-educated, older, and African-American citizens); McGlawn v. Pa. Human Relations Comm'n, 891 A.2d 757 (Pa. Commw. Ct. 2006) (finding that brokerage firm targeted African Americans through advertising in sources "oriented toward African American audiences"). *See generally* National Consumer Law Center, Credit Discrimination Ch. 8 (5th ed. 2009).

[24] Robert DeYoung & Ronnie J. Phillips, Federal Reserve Bank of Chicago, Strategic Pricing of Payday Loans: Evidence from Colorado, 2000–2005, at 20, 22 (July 14, 2006), *available at* www.chicagofed.org/cedric/2007_res_con_papers/car_48_deyoungphillips_fedcommaffairsconf_715_preliminary.pdf (finding, in preliminary results, that repeat borrowers, i.e., borrowers who were "flipped" into a new payday loan, were charged more than one-time borrowers).

[25] Government Accountability Office, Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosure to Consumers 38 (2006) (GAO-06-929), *available at* www.gao.gov/new.items/d06929.pdf.

[26] U.S. Dep't of Educ., National Ctr. for Educ. Statistics, Adult Literacy in America (Sept. 1993) (available from the U.S. Gov't Printing Office, GPO stock number 065-000-00588-3), *discussed in*, *e.g.*, Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13.2 Stan. L. & Pol'y Rev. 233, 235–242 (2002); Mary Jordan, *Literacy of 90 Million Is Deficient*, Washington Post, Sept. 9, 1993, at A1). *Cf.* Mark Kutner, Elizabeth Greenberg, Ying Jin, Bridget Boyle, Yung-Chen Hsu, Eric Dunleavy & Sheida White, Literacy in Everyday Life: Results from the 2003 National Assessment of Adult Literacy 13 (2007), *available at* http://nces.ed.gov/Pubs2007/2007480.pdf (22% of the U.S. population has less than basic proficiency in quantitative literacy).

[27] *See, e.g.*, Michael LaCour-Little & Cynthia Holmes, *Prepayment Penalties in Residential Contracts: A Cost-Benefit Analysis,* 19 Housing Pol'y Debate 631, 631–632 (2008) ("Given the embedded options they contain, mortgages are among the most complex of financial instruments.").

bank deposit slip.[28] Compare those tasks to understanding a typical mortgage or promissory note. Worse, the overwhelming majority of the U.S. population does not understand how to calculate interest, given the amount borrowed on a loan and the number and amount of payments. The 1992 National Assessment of Adult Literacy used a typical advertisement for a home equity loan as one of its measures of "quantitative literacy," and only 4% of the adults sampled could calculate how much interest would be charged.[29] Deficiencies in quantitative literacy are particularly pronounced for non-whites and older consumers,[30] precisely those groups most often targeted by abusive lenders.

If a straightforward interest calculation that involves nothing more than multiplication (multiply the number of payments by the payment amount) and subtraction (subtract the loan principal) is beyond the reach of most consumers, moderately complex products, like adjustable-rate mortgages, are completely beyond consumers' limited financial and quantitative literacy.[31] The surge in what are charitably called "non-

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[28] U.S. Dep't of Educ., National Ctr. for Educ. Statistics, Adult Literacy in America (Sept. 1993) (available from the U.S. Gov't Printing Office, GPO stock number 065-000-00588-3), *discussed in*, *e.g.*, Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13.2 Stan. L. & Pol'y Rev. 233, 235–242 (2002); Mary Jordan, *Literacy of 90 Million Is Deficient*, Washington Post, Sept. 9, 1993, at A1. *Cf.* Mark Kutner, Elizabeth Greenberg, Ying Jin, Bridget Boyle, Yung-Chen Hsu, Eric Dunleavy & Sheida White, Literacy in Everyday Life: Results from the 2003 National Assessment of Adult Literacy 13 (2007), *available at* http://nces.ed.gov/Pubs2007/2007480.pdf (22% of the U.S. population has less than basic proficiency in quantitative literacy).

[29] U.S. Dep't of Educ., National Center for Educ. Statistics, Adult Literacy in America 100 (Sept. 1993). (The ad included all the information necessary to make the calculation: number and amount of monthly payments, and loan principal.) *Cf.* Annamaria Lusardi & Olivia S. Mitchell, *Baby Boomer Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth*, 54 J. Monetary Econ. 205, 207, 216 (2007) (finding that less than 18% of surveyed adults between the ages of 51 and 56 could calculate compound interest at 10% on $200 over 2 years); Macro Int'l, Inc., Design and Testing of Effective Truth in Lending Disclosures 52 (2007), *available at* www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf ("[V]ery few participants could accurately describe how interest charges were accurately calculated"); Danna Moore, Wash. St. U., Soc. & Econ. Sci. Research Ctr., Survey of Financial Literacy in Washington State: Knowledge, Behavior, Attitudes, and Experiences (Tech. Rep. 03-39, 2003), *available at* www.dfi.wa.gov/news/finlitsurvey.pdf (finding approximately 30% of respondents do not understand that if interest compounds, it builds on itself); Annamaria Lusardi & Olivia S. Mitchell, Financial Literacy and Planning: Implications for Retirement Wellbeing 4, 7 (Pension Research Council, Working Paper No. 1, 2006), *available at* www.dartmouth.edu/~alusardi/Papers/FinancialLiteracy.pdf (noting that only 67% of surveyed adults, many over 50, could correctly determine whether, after 5 years of interest at 2% on $100, they would have less than, more than, or exactly $102).

[30] Mark Kutner, Elizabeth Greenberg, and Justin Baer, U.S. Department of Education, National Center for Education Statistics, A First Look at the Literacy of America's Adults in the 21st Century 1, 10 (Dec. 2005), *available at* http://nces.ed.gov/NAAL/PDF/2006470.PDF.

[31] *See* Consumer Fed. of Am., Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages 3 (July 26, 2004), *available at* www.consumerfederation.org/releases.cfm#Consumer%20Literacy (consumers cannot calculate the increase in the payment in an adjustable-rate mortgage and minimize the interest rate risk by understating the increase in the payment; problem is present for all categories, but particularly pronounced for younger, poorer, less educated, and non-white consumers); Brian Bucks & Karen Pence, Do Homeowners Know Their House Values and Mortgage Terms? 18–22 (Fed. Res. Bd. of Governors Fin. & Econ. Discussion Series Working Paper No. 2006-3), *available at*

traditional" mortgage products leading up to the economic collapse in 2007 exploited gaps in consumer understanding. These products typically multiply the inherent complexity of an adjustable-rate mortgage (ARM) by layering other complex and risky traits on top. The two most common types of new, risky, products are the payment option ARM and the interest-only ARM, but other variations including 40-year and interest-only mortgages also gained significant market share leading up to the market crash in 2007. Without doubt, neither creditors nor consumers understood the products nor the risks inherent in them.[32] As the Federal Reserve Board acknowledges, and many cases have determined, the disclosures required at the time failed to convey the pricing of these products.[33] Indeed, we believe, that *no* disclosures could make some of these products comprehensible, and this fair.

Existing disclosures utterly fail to convey the pricing of these products.[34] Attempts to improve these disclosures, while necessary, will not succeed in protecting most consumers from what are inherently unfair and inappropriate credit products.[35] The

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www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf (borrowers, particularly low-income borrowers, underestimate caps on life time interest rates in adjustable-rate mortgages).

[32] *See, e.g., 8 Billion in Mortgage Overcharges Seen*, L.A. Times, June 30, 1990, at D-5 (reporting on studies showing errors in computing payments on adjustable-rate loans in over half of 7000 loans sampled).

[33] *E.g.*, O'Donnell v. Bank of Am., 2009 WL 765670 (N.D. Cal. Mar. 20, 2009) (finding, for purposes of surviving a motion to dismiss, that a POARM payment schedule in compliance with Regulation Z is nonetheless a violation of TILA's requirement that negative amortization by clearly and conspicuously disclosed); Amparan v. Plaza Home Mortgage, Inc., 2008 WL 5245497 (N.D. Cal. Dec. 17, 2008) (applying equitable tolling to TIL damage claim since POARM disclosures confusing and denying lender's motions to dismiss TIL claims based on failure to disclose "the true cost of the loan," although composite APR correctly disclosed); James M. Lacko & Janis K. Pappalardo, Fed. Trade Comm'n, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms, at ES-11 (2007), *available at* www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (prime borrowers have difficulty answering questions about their loans; difficulty increases as loan becomes more complex).

[34] *E.g.*, O'Donnell v. Bank of Am., 2009 WL 765670 (N.D. Cal. Mar. 20, 2009) (finding, for purposes of surviving a motion to dismiss, that a POARM payment schedule in compliance with Regulation Z is nonetheless a violation of TILA's requirement that negative amortization by clearly and conspicuously disclosed); Amparan v. Plaza Home Mortgage, Inc., 2008 WL 5245497 (N.D. Cal. Dec. 17, 2008) (applying equitable tolling to TIL damage claim since POARM disclosures confusing and denying lender's motions to dismiss TIL claims based on failure to disclose "the true cost of the loan," although composite APR correctly disclosed); James M. Lacko & Janis K. Pappalardo, Fed. Trade Comm'n, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms, at ES-11 (2007), *available at* www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (prime borrowers have difficulty answering questions about their loans; difficulty increases as loan becomes more complex); Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 Harv. J. on Legis. 123, 133–134 (2007) ("The New York Times recently advised borrowers with exotic adjustable-rate mortgages to figure out their maximum monthly payments by consulting 'mortgage payment calculators on the Web'--not their TILA disclosures"), and at 143–144 (discussing limitations of variable rate disclosures in detail).

[35] *See, e.g.*, Truth in Lending, 73 Fed. Reg. 1,672, 1,675–1,677 (Jan. 9, 2008) (discussing limits of disclosure in the subprime mortgage market); William C. Apgar & Christopher E. Herbert, U.S. Dep't of Hous. & Urban Dev., Subprime Lending and Alternative Financial Service Providers: A Literature Review and Empirical Analysis § 2.2.3, at 1-15 (2006) ("Unfortunately, given the bewildering array of mortgage products available, even the most sophisticated borrower will find it difficult to evaluate the details of a mortgage.").

complexity of the products now exceeds what most consumers, even educated consumers, are capable of comprehending.[36]

3. Board's Testing Indicates That Disclosure Is Often Insufficient

The Board's recent testing of the proposed disclosures for complex mortgage loans illustrates that even when specially designed disclosures are shown to consumers about the complexities of their mortgages, many fail to appreciate the costs and risks.[37] Important points gleaned from the report of the testing completed for these proposed regulations include:

- Consumers had persistent difficulty identifying and understanding teaser rates despite many attempts to redesign the disclosure.[38]
- Consumers had difficulty understanding negative amortization.[39]
- Few participants understood the difference between the principal and the amount financed or between the interest rate and the APR, even after multiple attempts to rephrase the disclosures.[40]
- Even after many revisions and improvements, consumers misunderstood much of the information on the TIL disclosure.[41]

  They were confused about whether settlement charges were included in, or in addition to, the stated loan amount; they did not understand the APR or why it was different from the interest rate; two out of ten did not understand that there was no limit on how high the APR could go; most found interest rate increases in an interest-only ARM confusing after the first adjustment; only half could identify the maximum amount their rate could increase in a year; two of ten participants who reviewed a payment option ARM did not understand that the minimum payment would increase over time, two thought the minimum payment covered all interest, and two did not understand that making the minimum payments would cause the loan balance to increase; three participants thought that signing

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[36] *See* James M. Lacko & Janis K. Pappalardo, Fed. Trade Comm'n, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms, at ES-11 (2007), *available at* www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (prime borrowers have difficulty answering questions about their loans; difficulty increases as loan becomes more complex); Comments of the Ctr. for Responsible Lending on Advance Notice of Proposed Rule-Making, Regulation Z, Subpart B: Open-End Credit 22 (Mar. 28, 2005), *available at* www.responsiblelending.org/pdfs/Comment_FRB032805.pdf ("[C]ollege-educated consumers consistently underestimate[] how long it would take to pay off credit card balances."); Wiliam C. Apgar, Allegra Calder, & Gary Fauth, Jt. Ctr. for Housing Studies, Harvard University, Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations 40, 50–51 (Mar. 2004), *available at* www.jchs.harvard.edu/publications/communitydevelopment/ccc04-1.pdf (discussing inability of even sophisticated consumers to understand mortgage products).

[37] ICF Macro, *Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages* (July 1, 2009), *available at* www.federalreserve.gov/boarddocs/meetings/2009/20090723/Full%20Macro%20CE%20Report.pdf.

[38] *Id.* at 28, 36, 53, 69.

[39] *Id.* at 38.

[40] *Id.* at 10-11, 52.

[41] *Id*. at. 68-73.

the acknowledgment of receipt of the disclosure statement amounted to a commitment to go through with the loan.

Moreover, the entire premise of basing consumer protection on disclosures assumes that consumers will actually shop and compare different loan products. The Board's testing showed that shopping for home mortgages is largely a myth. Only about half of research participants consulted more than even one lender or broker when looking for a mortgage loan.[42]

4. Disclosures Cannot Always Cure Systematic Consumer Confusion Regarding Credit

Legal scholars and behavioral economists have applied well-established insights of psychology to demonstrate that many, if not most, consumers make systematic errors of judgment in evaluating credit.[43] Most consumers, even educated consumers, focus on the payment to estimate the cost of a loan.[44] This focus on the payment works fine as a short-cut if the loans being compared are fixed-rate loans of the same time to repay; it gravely misleads borrowers comparing loans of different lengths or with adjustable-rate periods. Worse, virtually all consumers, when given a payment stream, underestimate the effective interest, on average by as much as thirty-eight percentage points.[45] Because credit defers payments into the future, most consumers heavily discount the actual cost of repaying that credit, and so purchase more on credit than they would with cash and

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[42] *Id.* at 5.

[43] *E.g.*, Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 Yale J. on Reg. 181 (2008); Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 Minn. L. Rev. 749, 761–765 (2008); Oren Bar-Gill, *Bundling and Consumer Misperception*, 73 U. Chi. L. Rev. 33, 45 (2006); Susan Block-Lieb, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided "Reform" of Bankruptcy Law*, 84 Tex. L. Rev. 1481 (2006); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price* 65 Md. L. Rev. 707 (2006); Matthew A. Edwards, *Empirical and Behavioral Critiques of Mandatory Disclosure: Socio-Economics and the Quest for Truth in Lending*, 14 Cornell J.L. & Pub. Pol'y 199, 221–223 (2005); Jason J. Kilborn, *Behavioral Economics, Overindebtedness & Comparative Consumer Bankruptcy: Searching for Causes and Evaluating Solutions*, 22 Emory Bankr. Dev. J. 13, 18–19 (2005); Patricia A. McCoy, *Elder Law: A Behavioral Analysis of Predatory Lending*, 38 Akron L. Rev. 725, 734 (2005) (detailing the difficulties faced by shoppers for subprime mortgage loans); Oren Bar-Gill, *Seduction by Plastic*, 98 Nw. U. L. Rev. 1373 (2004); Jeff Sovern, *Toward a Theory of Warranties in Sales of New Homes: Housing the Implied Warranty Advocates, Law and Economics Mavens, and Consumer Psychologists Under One Roof*, 1993 Wis. L. Rev. 13 (1993); Ren S. Essene & William Apgar, Joint Ctr. for Housing Studies, Harvard Univ., Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans (2007).

[44] *See, e.g.*, Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price* 65 Md. L. Rev. 707 (2006); Ren S. Essene & William Apgar, Joint Ctr. for Housing Studies, Harvard Univ., Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans (2007).

[45] The median underestimation was 25 percentage points. Victor Stango & Jonathan Zinman, How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets 3–4 (Sept. 5, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928956.

borrow more heavily than is prudent.[46] Similarly, consumers tend to underestimate how much they will borrow in the future, compounding the tendency toward overextension.[47]

An unregulated free market system rewards creditors who understand and take advantage of these systematic biases to hide the real cost of credit.[48] Little wonder then that too many creditors understate or obscure the real cost of credit (sometimes as permitted by law, other times not).[49]

Disclosure is not an adequate counterweight to creditor overreaching.[50] In a country in which nearly 40% of the population is estimated to be functionally illiterate,[51]

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[46] *See, e.g.,* Jason J. Kilborn, *Behavioral Economics, Overindebtedness & Comparative Consumer Bankruptcy: Searching for Causes and Evaluating Solutions*, 22 Emory Bankr. Dev. J. 13, 18–19 (2005).
[47] *See, e.g.,* Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 Minn. L. Rev. 749, 777 (2008); Jinkook Lee & Jeanne M. Hogarth, *Relationships Among Information Search Activities When Shopping for a Credit Card*, 34 J. Consumer Aff. 330, 333 (2000).
[48] *See* Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 Minn. L. Rev. 749, 789 (2008) (arguing that consumer misperceptions cause market distortions in pricing and other attributes of credit).
[49] *See, e.g.*, Miller v. Americor Lending Group, Inc., 2007 WL 107664 (W.D. Mich. Jan. 9, 2007) (broker offers to arrange fixed-rate, non-negatively amortizing, pick-a-payment 2% interest rate loan and provides initial Truth in Lending disclosures, although knew no such loan existed); Fed. Trade Comm'n v. Chase Fin. Funding, Inc., No. SACV04-549, Complaint, at 4 (C.D. Cal. May 12, 2004), *available at* www.ftc.gov/os/caselist/0223287/040602comp0223287.pdf (adjustable-rate mortgage with initial minimum payment, based on interest at 3.5% amortized over 30 years, which results in negative amortization, since actual interest rate is much higher, advertised as "3.5% fixed payment 30 year loan"); Nationscapital Mortgage Corp. v. State Dep't of Fin. Inst., 137 P.3d 78, 83–84 (Wash. Ct. App. 2006) (broker apparently had pattern of representing on Truth in Lending disclosures that borrower not responsible for broker fee); Gov't Accountability Office, GAO No. 06-1021, Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved 22 (2006), *available at* www.gao.gov/new.items/d061021.pdf (describing advertisement for payment option ARM that promised 45% reduction in monthly mortgage payments and interest rate of 1.25%; interest rate of 1.25% only applied for first month, and this fact disclosed in "much smaller print" on second page); John R. Wilke, *Hidden Fees in Most Mortgages Bring Scrutiny to Fannie, Freddie*, Wall St. J., Jan. 14, 2005, at A1 (reporting on guarantee fees paid by lenders to Fannie Mae and Freddie Mac that are packaged in the interest rate and undisclosed to borrowers; averaging two-tenths of a percent of the loan amount per month).
[50] *See* Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 Akron L. Rev. 725 (2005) (discussing the cognitive barriers to decision making in the predatory lending context); Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 Banking L.J. 483, 546 (2005) (borrowers, due to a variety of psychological effects, tend to underestimate the risk of foreclosure); A. Mechele Dickerson, *Bankruptcy and Mortgage Lending: The Homeowner Dilemma*, 38 J. Marshall L. Rev 19, 42–47 (2004) (discussing limitation of financial literacy and disclosures due to cognitive biases).
[51] U.S. Dep't of Educ., National Ctr. for Educ. Statistics, Adult Literacy in America (Sept. 1993) (available from the U.S. Gov't Printing Office, GPO stock number 065-000-00588-3), *discussed in*, *e.g.*, Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13.2 Stan. L. & Pol'y Rev. 233, 235–242 (2002); Mary Jordan, *Literacy of 90 Million Is Deficient*, Washington Post, Sept. 9, 1993, at A1). *Cf.* Mark Kutner, Elizabeth Greenberg, Ying Jin, Bridget Boyle, Yung-Chen Hsu, Eric Dunleavy & Sheida White, Literacy in Everyday Life: Results from the 2003 National Assessment of Adult Literacy 13 (2007), *available at* http://nces.ed.gov/Pubs2007/2007480.pdf (22% of the U.S. population has less than basic proficiency in quantitative literacy).

the concept of disclosure loses meaning. Nor does disclosure prevent overshadowing by salespeople, paid on commission to sell loans.[52]

D. *Payment Option ARM Loans Are So Inherently Deceptive That Few, If Any Borrowers Can Understand How They Work*

Consider the typical confusing information and signals provided in a standard payment option ARM loan. In this case, Mr. Williams (a real consumer in a Southern state whose name has been changed to protect his privacy) was an older homeowner, with a college education, excellent credit and a healthy income more than sufficient for the monthly payment on the loan that he sought *if it had been a standard 30-year, fully amortizing mortgage.* He was persuaded by a loan broker to sign a payment option ARM loan in late August 2006, with payments for the first year based on the 2% initial interest rate. The 2% rate was scheduled to change within 30 days after he signed the loan documents, although the payments would remain the same for a year, meaning that so long as Mr. Williams made the initial payment his loan balance would increase each month by the amount of interest that he was *not paying.* At closing, when Mr. Williams raised questions about the complexity of the terms, the broker assured him it was all "legalese" and that the contract was just as promised—an adjustable rate loan with a very low initial rate of 2%.

The TIL disclosures provided to Mr. Williams to describe the adjustable nature of this loan have already been acknowledged by the Board to be completely inadequate (why else would there be the proposed massive rewrite of those disclosures in the present rules?). However, the Note provided to Mr. Williams was itself inherently deceptive, and therefore misleading.

Very, very few consumers actually attempt to read their Note at or before the closing of their mortgage. But, had Mr. Williams carefully read the Note[53] that he signed, he would no doubt have been confused. In the second paragraph, the one labeled "2. Interest" the first subsection says:

> **(A) Interest Rate**
> Interest will be charged on the unpaid Principal until the full amount of Principal has been paid. I will be charged interest at a yearly rate of 2.000%. The interest rate I will pay *may* change. [Emphasis Added.]

Even in the next paragraph, where there is a discussion of the first date on which the interest rate change could occur, the word is "may":

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[52] *See, e.g.*, *In re* First Alliance Mortgage Co., 298 B.R. 652 (C.D. Cal. 2003); Diana B. Henriques and Lowell Bergman, *Mortgaged Lives: A Special Report; Profiting from Fine Print with Wall Street's Help*, N.Y. Times, Mar. 15, 2000, at A1 (reporting on allegations against First Alliance Mortgage about its sales tactics).

[53] See Appendix II, *infra*, Williams Adjustable Rate Note.

> **(B) Interest Rate Change Dates**
> The interest rate I will pay *may* change on the 1st day of October, 2006 . . . .

A person who is knowledgeable about interest rates and about how these contracts work would think that these statements that the interest rate "may" change, mean that there was a possibility that the interest rate would *not* change. Yet, under the terms of this loan, the interest rate absolutely, positively *had* to change because come the first change date, the applicable interest rate would be determined based on the index,[54] plus a margin of 3.45%. So even if the index was 0.5% (which was highly unlikely at the time, but has actually come to pass in these recessionary days), the lowest the rate could be is the combination of the index plus the margin, or 3.95%. The contract's application of the interest rate change to even the lowest possible rate after the first month would thus *require* a change from 2% to *at least* 3.95%. So the use of the word "may" in the Note was unquestionably misleading.

The information about how Mr. Williams' payments would cover principal is just as confusing. In paragraph 3, labeled "Payments" the borrower promises:

> I will make my monthly payments on the 1st day of each month beginning on October, 2006. I will make *these* payments every month until I have paid all the Principal and Interest and any other charges described below that I may owe under this Note. Each monthly payment will be applied as of its scheduled due date and *will be applied to interest before Principal.* ...[Emphasis Added.]

This clearly indicates to the reader that by making the described monthly payments, both interest and principal will be paid. Further, there is every indication that the payment articulated as the "initial monthly payments might *not* change:

> **(C) Payment Change Dates**
> My monthly payment *may change.* ... [Emphasis Added.]

Yet, there is absolutely no possible scenario in which the payments on Mr. Williams' Note will *not* change; indeed, under the terms of the Note, the payments had to increase, substantially.

Based on the terms of this—and every other payment option ARM loan we have seen—to determine whether the initial payments actually do cover both the interest

[54] The Index for this and most other Payment Option ARM Loans is "the 'Twelve-Month Average' of the annual yields on actively traded United States Treasury Securities adjusted to a constant maturity of one year as published by the Federal Reserve Board in the Federal Reserve Board Statistical Release entitled 'Selected Interest Rates (H.15)' (the 'Monthly Yields'). The Twelve Month Average is determined by adding together the Monthly Yields for the most recently available twelve months and dividing by 12. The most recent Index figure available as of the date 15 days before each Interest Rate Change Date is called the "Current Index..." Note, Paragraph 2(C).

charged each month as well as some extra to pay down the principal, one must take each of the following steps:

1. Determine the interest rate index at the time loan was made.
2. Determine what the index might change *to* and determine *when* it might change.
3. Determine the applicable interest rate by combining the index with the margin specified in the Note.
4. Using either a computer spreadsheet or a specialized financial calculator apply the formula to determine what the payments should be at each of the payment change dates—occurring yearly on this loan until the reset occurs.
5. Using a computer spreadsheet create a loan amortization using these derived figures.
6. Manually change the loan amortization when: a) the payments are changed per the contract terms; b) when the applicable interest rate changes (per the contract, based on the Index plus the Margin); and c) again when the principal is increased to 115% of the original balance. Moreover, according to the Note, the interest rate must be rounded to the nearest 0.125%.[55]

This is too much for any consumer to have to figure out.

E. *The Dangers of Payment Option ARM Loans Outweigh Any Temporary Benefits*

Why would anyone deliberately—knowingly—obtain a payment option ARM loan? It is true that the payments for the first few years of a payment option ARM loan *are* considerably lower than the payments on an equivalent 30-year fixed rate, fully-amortizing mortgage. Yet, evaluating all of the costs of the loan illustrates that the benefits of lower payments for a few years do not begin to outweigh the significant risks and costs associated with a payment option ARM.

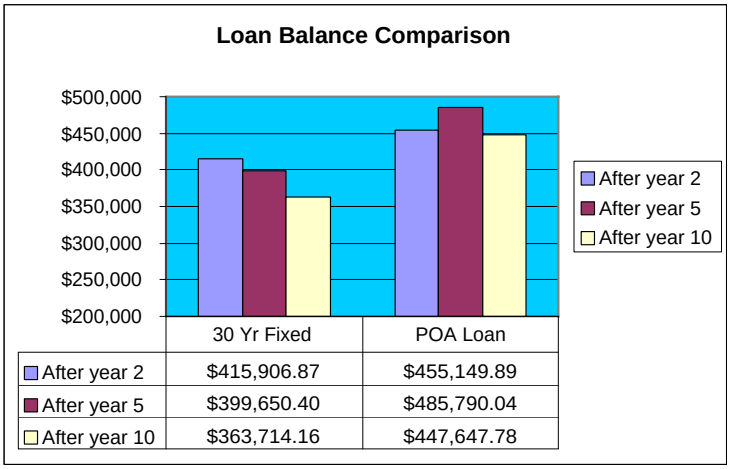
The benefits from the early low payments are short-lived, to be replaced by much higher payments than would not have been necessary if the payments were in the same amount throughout the loan term. Mr. Williams' loan payments jumped from a low of $1,804.63 (this was the amount based on the 2% interest rates applicable only for the first month) made in the first year to more that twice that amount in year four: $3,945.16.

When Mr. Williams received this payment option ARM loan, he was already a senior citizen. While his income was healthy at the point he took out this loan, it indisputably would decrease in the coming years, as he grew older. Despite the fact that his income would go down, on this payment option ARM loan, his payments would increase—by over 200% (from $1,804.63 to $3,945.16). This increase in payments—known as "payment shock"—subjects him to a substantial risk of not being able to make his payments at all—and thus risking foreclosure and the loss of his home.

[55] See Appendix II, *infra,* Williams Adjustable Rate Note, Paragraph 2(D).

While there were few savings from the initially reduced payments in the payment option ARM loan, the *cost* in lost equity is dramatic. Consider how much more Mr. Williams owes on the payment option ARM loan at various points during the loan term than he would have owed had he been provided a standard fully amortizing loan. In the 30-year fully amortizing loan, every payment would have reduced Mr. Williams' principal. In the payment option ARM loan, the payments during the initial four and a half years are designed to be insufficient to cover even the interest due, so that the amount Mr. Williams owes climbs.

The only reason to give Mr. Williams a payment option ARM loan was because the lender and the broker made more money from it than they would have from a safer, 30-year fixed rate, fully amortizing loan. In the payment option ARM loan made to Mr. Williams, the broker received a yield spread premium. A yield spread premium is a payment made by the lender to the broker, which is paid for by the borrower through an increase in the interest rate. The lender is guaranteed a sufficient return on the loan to cover the yield spread through the imposition of a prepayment penalty. In this case, the yield spread premium was $14,734.75, in addition to the other fees (not including daily interest) which the broker received on this loan, a sum of $17,839.75.



	30 Yr Fixed	POA Loan
After year 2	$415,906.87	$455,149.89
After year 5	$399,650.40	$485,790.04
After year 10	$363,714.16	$447,647.78

Between the inherent complexities and the complete lack of positive benefit for homeowners, payment option ARM loans are intrinsically unfair. They might conceivably be appropriate for some, very sophisticated investors who understand finance. However, they are not suitable instruments to be secured by a family home. The Board should use its unfairness authority to simply ban them when secured by a consumer's principal residence:

The Board should prohibit all payment option ARM loans.

F. *The Board Should Extend the Ability to Repay Standard to All Home Loans*

Last year, in the 2008 changes to TILA's regulations, the Board extended rules requiring creditors to determine the borrower's ability to repay the loan to a new class of "higher-cost" loans.[56] Like the rules previously applicable only to HOEPA loans, at consummation, the consumer's total monthly debt payments, including amounts owed under the mortgage, cannot exceed fifty percent of the consumer's monthly income.[57]

[56] 73 Fed. Reg. 44,522, 44,603 (July 30, 2008); Regulation Z § 226.32(d).
[57] Regulation Z § 226.32(d)(7)(iii).

However, the verification requirements differ from the HOEPA rules but track a new verification regime applicable to the repayment ability standard in revised Regulation Z § 226.34(a)(4).

These new repayment rules will significantly reduce bad underwriting in subprime loans. But there is absolutely no reason for prime loans not to be covered by the same protections. The delinquency statistics for prime adjustable rate loans—currently at an all time high of almost 17%—is itself an indication that these prime, low-cost loans were not adequately underwritten. The current crisis in the mortgage market illustrates that while subprime lending allowed the most problems, prime lending had its share as well.

The prime market is not exempt from abuses. As the Board recognizes now with the prohibitions on certain yield spread premiums, lenders have paid brokers inappropriate yield spread premiums—without transparency or the consent of borrowers—in the prime market for years.[58] Lenders in the prime market have particularly contributed to the current foreclosure crisis by making no documentation loans.

When lenders in any part of the market shrug off prudent banking practices, such as verification and assessment of ability to repay, the consequences are significant. Payment option ARM loans—which are generally prime loans—are a leading cause for the ongoing foreclosure crisis, largely because of the failure to underwrite for the increased payments.[59] Nearly $750 billion in these loans were issued between 2004 and 2007, and they are a substantial cause of the foreclosure crisis facing the United States.[60] Yet they were largely issued to prime borrowers, and for that reason, they are still considered prime loans.[61]

Despite the 2006 Guidance from federal regulators somewhat increasing the requirements on lenders for "non-traditional mortgages," it is quite clear that the loans written *after* the pronouncements are expected to default at a greater rate than those written before. According to a *Wall Street Journal* article published earlier this year, based on reports issued by Goldman Sachs and Countrywide: As of December 2009, 28% of option ARMs were delinquent or in foreclosure, according to LPS Applied Analytics, a data firm that analyzes mortgage performance. Nearly 61% of payment

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[58] The Department of Housing and Urban Development has been struggling with this type of compensation since at least 1992. See Supplementary Information , Real Estate Settlement Procedures Act (RESPA) Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, 64 Fed. Reg. 10,080, 10,080 (Mar. 1, 1999) (reporting that it conducted rulemakings on three occasions in the previous seven years; promulgating a policy statement that applied to the entire mortgage lending market; discussing why these payments were "particularly troublesome" for consumers and industry).

[59] Citing Susan Wachter, a professor of real-estate finance at the University of Pennsylvania's Wharton School in Philadelphia. Brian Louis, Bloomberg News, *Option ARMs Reset Threatens Housing Rebound*, The Seattle Times, June 27, 2009, *available at* http://seattletimes.nwsource.com/html/realestate/2009389569_optionARMs280.html;

[60] Ruth Simon, *Option Arms See Rising Defaults,* Wall Street Journal, January 30, 2009.

[61] *Id*.

option ARMs originated in 2007 will eventually default, according to a recent analysis by Goldman Sachs, which assumed a further 10% decline in home prices. That compares with a 63% default rate for subprime loans originated in 2007. Goldman estimates more than half of all payment option ARMs outstanding will default.[62]

Over fifty percent of these prime loans written *after* the 2006 Guidance are expected to default because they were made by creditors who only evaluated the borrower's ability to make the first year's payments.[63] Or, because the creditors based their entire evaluation on stated income underwriting, in which the creditors deliberately hid real information about the borrower's ability to repay from underwriters and investors—replacing the borrower's credit score with a determination of the borrower's ability to pay the increasing payments required by payment option ARM and interest only loans.

For example, Chevy Chase Bank instructed loan brokers to "black out" any income information on Social Security letters and on IRS Schedule B forms in its Stated Income Loan Origination Guidelines—Wholesale Lending Division.[64] Indymac Bank instructions state: "Completed typed 1003 Application with no reference to income or assets. The file must not contain any documents that reference income or assets."[65]

Unfortunately, this only makes clear that non-binding guidance and statements from federal regulators are not sufficient to change the marketplace. And it is up to the Board to cover *all* mortgage loans in the marketplace. The Board should:

Apply the current ability to repay requirements in Regulation Z § 226.35(b) to the all loans secured by a principal residence.

G. *The Board Should Require That All Home Secured Mortgage Loans Are Underwritten for the Maximum Possible Payment*

We heartily applaud the Board's decision to require disclosure for adjustable rate loans to be based upon the maximum possible payment. This is an important and helpful change from disclosures based on the fully indexed rate. Now, the Board simply needs to require that creditors *underwrite* to the maximum possible payment as well.

The Board seems to be well aware of the problems with using the fully indexed rates as the basis for disclosures. The fully indexed rate will *never* actually be the rate that is charged to the borrower. It is a fictional rate which is based on the application of the index at or shortly prior to origination plus the margin that will apply at the end of the

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[62] Ruth Simon, *Option Arms See Rising Defaults,* Wall Street Journal, Jan. 30, 2009.

[63] *See, e.g.*, American Home Mortgage Assets, L.L.C. Prospectus supplement dated August 29, 2006 (to prospectus dated April 21, 2006), American Home Mortgage Assets Trust 2006-4; Issuing Entity: American Home Mortgage Servicing, Inc.; Servicer: American Home Mortgage Corp. showing that the lender *underwrote these POA loans only for the first year's payments* (at 9).

[64] *See* Appendix III, *infra*, Chevy Chase Bank, F.S.B.-Wholesale Lending Division, Loan Origination Guidelines.

[65] See Appendix IV, *infra,* IndyBank Conditional Approval Notice.

first (two or three year) period of fixed rates. If, as is almost certain to be the case, the index rate changes during the fixed-rate period, the rate that will apply at the end of the fixed rate period will be different from the "fully indexed rate" that was calculated when the loan was originated. Assessing the affordability of a loan based on a rate that will never actually be applied to it makes little sense.[66] Instead the Board must require an assessment based on the maximum possible rate. This will undoubtedly have the effect of forcing creditors to *lower* the maximum possible rate which can be charged. Lowering the maximum rate makes a lot of sense, as it protects the more vulnerable and less sophisticated of the two parties in the mortgage transaction from the vagaries of the mortgage marketplace—the homeowner.

When the five federal regulators (including the Board) issued the 2006 Guidance and Statement dealing with non-traditional and subprime mortgages, respectively, it was recognized that *some* underwriting standards are necessary to require of creditors who make adjustable rate loans. At the time, mandating the fully indexed rate was a step forward—although apparently not sufficient to mandate real underwriting to determine actual affordability, as is evident from the current delinquency rates of both subprime and prime adjustable rate mortgages.

When dealing with non-traditional mortgages like payment option ARM loans and interest only (IO) loans, there is an additional complexity, other than the appropriate interest rate which should be charged. That is that the actual amortization period for the repayment of the loan principal is much shorter than the term of the loan. For example, on a typical 5-year IO loan, the borrower is permitted to make the interest only payments for the first five years, and then required to repay the entire mortgage balance in the remaining twenty-five years.

Over 80% of all borrowers on these non-traditional loans make the minimum payments—so although they could have paid more than the interest due on the loan, the vast majority do not.[67] Yet, the creditors for these loans are permitted to underwrite as if the borrowers will make the fully amortizing payment.

The difference between the amount of the payments on which the borrower's ability to repay the loan has been determined and the *actual* payments that are required for the borrower to make when the payments reset is dramatic. Consider the following example of a $500,000 IO loan, with a fixed rate of 7%, in which the borrower is permitted to make interest only payments for the first five years:

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

[67] Joint Ctr. for Hous. Studies, State of the Nation's Housing 2007, at 17.

Interest Only Payments—(First 5 Years)	Payments Required for Remaining 25 Years	Fully Amortizing Payments—Loan Amount Repaid Over 30 Years
$2,916.67	**$3,533.90**	**$3,326.51**

A creditor making this loan would be required to evaluate the borrower's ability to make payments of $3,326.51, despite the fact that history illustrates 80% of borrowers will end up being required to make the payments of $3,533.90. So the underwriting will be based on payments which almost 10% less than the payments than will actually be required. This makes no sense.

As a result, the Board should require:

All underwriting for adjustable payment loans be for the maximum possible payment, considering both the highest applicable interest rate and the shortest applicable term to the payment schedule.

H. *The Board Should Prohibit the Initiation of a Foreclosure Unless the HAMP Loan Modification Analysis and Procedure Have Been Completed*

Despite enormous public pressure and federal resources, to date, the federal government's ambitious Home Affordable Modification Program (HAMP), designed to stem the tide of foreclosures by establishing affordable loan modifications, has only finalized only a tiny number of loan modifications.[68] Indeed, there are only 650,000 temporary 3-month payment plans with homeowners since the program started in April.[69]

These dismal numbers for loan modifications make little sense when one realizes that the test for loan modifications is based on whether the *investor* will do better from an affordable loan modification than from a foreclosure.

Servicers, unlike investors or homeowners, do not generally lose money on a foreclosure. Servicers may even make money on a foreclosure. And, usually, a loan modification will cost the servicer something. A servicer deciding between a foreclosure and a loan modification faces the prospect of near certain loss if the loan is modified, and no penalty—but potential profit—if the home is foreclosed. The formal rulemakers—Congress, the Administration, and the Securities and Exchange Commission—and the market participants who set the terms of engagement—credit rating agencies and bond

[68] We do not know the November numbers, because Treasury has not reported the number of final modifications that month, however, based on the October figures, there were fewer than 1,800 permanent modifications. Nearly half of those permanent mods were done by a single servicer, Ocwen. Alan White, Home Affordable's Weak Start, Public Citizen, Consumer Law and Policy Blog, Monday, October 12, 2009, *available at* http://pubcit.typepad.com/clpblog/2009/10/by-alan-white----------two--important-reports-on-the-foreclosure-crisis-and-the-administrations-plan-to.html?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+ConsumerLawPolicyBlog+%28Consumer+Law+%26+Policy+Blog%29.

[69] Making Home Affordable Program, Servicer Performance Report Through October 2009, *available at* http://treas.gov/press/releases/reports/mha%20public%20111009%20final.pdf.

insurers—have failed to provide servicers with the necessary incentives—the sticks as well as the carrots—to reduce foreclosures and increase loan modifications.[70]

Servicers remain largely unaccountable for their dismal performance in making loan modifications. This situation is quintessentially unfair, and is one which the Board can and should address through its authority to prohibit unfair practices in the mortgage marketplace. The Board should:

> *Prohibit the initiation of a foreclosure unless the HAMP loan modification analysis and procedure have been completed*.[71]

III. FINANCE CHARGE DEFINITION: OVERVIEW & HISTORY—§ 226.4[72]

A. *Introduction: The Finance Charge Definition Should Be Inclusive and Uniform for All Kinds of Credit*

The legislators who enacted TILA hoped it would enhance competition in the marketplace and stabilize the national economy through disclosure.[73] Since that brave beginning, both Congress and the Board have largely undercut TILA's key disclosures, the finance charge and annual percentage rate (APR), by providing creditors with an ever-increasing list of exceptions.[74] The numerous exceptions follow at best a Byzantine logic and complicate creditors' compliance efforts and regulators' review. Failure to provide meaningful disclosure of the cost of credit may have played some role in the subprime mortgage debacle.[75]

The Board's proposal promises significant relief, at least for closed-end mortgage credit. The new direction—an "all-in" approach—would make the finance charge calculation more true to its basic statutory definition, by eliminating a swarm of

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[70] *See* Diane E. Elizabeth Thompson, National Consumer Law Center, Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior (Oct. 2009), *available at* http://www.nclc.org/issues/mortgage_servicing/content/Servicer-Report1009.pdf.

[71] We have many more specifics on this suggestion, which we will be happy to provide when the Board is interested in pursuing this recommendation

[72] The Board's proposal regarding the finance charge for HELOCs is discussed at Section II of those comments, reprinted at Appendix I, *infra*.

[73] *See, e.g.*, H.R. Rep. No. 90-1040 (1967), *as reprinted in* 1968 U.S.C.C.A.N. 1962, 1970 ("Significantly, no one segment of the industry feels it can afford to reform itself by disclosing an annual percentage rate without incurring a competitive disadvantage. Clearly, the only solution is to require by legislation that all creditors use the same method …."); *id.* at 1999–2000 (Supplemental Views of Leonor K. Sullivan) ("Out of the operations of this legislation should come needed help to the decent elements in this vital industry in overcoming unfair and dishonest competition from an unscrupulous minority engaging in practices which too often discredit credit and dishonor its ethics."); S. Rep. No. 96-368, at 16 (1979), *as reprinted in* 1980 U.S.C.C.A.N. 236, 252 (crediting TILA with a reduction in high cost credit from 1969 to 1979).

[74] *See generally* Elizabeth Renuart & Diane E. Thompson, *The Truth, The Whole Truth, and Nothing But The Truth: Fulfilling The Promise of Truth In Lending*, 25 Yale. J. Reg. 181, 209 (2008).

[75] Oren Bar-Gill, *The Law, Economics, and Psychology of Subprime Mortgage Contracts*, 94 C ornell L. Rev. 1073 (2009) (a rguing t hat an i mproved APR c ould ai d c onsumer-decision-making a nd i mprove competition and pricing in the subprime mortgage market).

exceptions that have undermined the accuracy and utility of the APR. The definition of the finance charge would not change. The allowable exclusions for mortgage credit would.

We strongly support the all-in approach to mortgage credit. It offers significant advantages to both consumers and creditors. It reinvigorates the principles on which TILA was based: empowering consumers to make informed choices and maintaining a fair marketplace.[76] A comprehensive APR would allow consumers to make a meaningful choice between products, as well as have an accurate understanding from the outset of what their chosen credit product will cost them. Benefits will flow to the economy as a whole as consumers have the information necessary to make prudent decisions, and lenders are required to engage in honest competition.

One real risk, however, with the Board's approach is that it adds complication in a new direction—separate finance charges for each variety of credit. Thus, while the finance charge and the APR should have increased utility within the closed-end mortgage category of credit, consumers may not be able to compare pricing on even closely-related varieties of credit such as home equity lines of credit (HELOCs). The ensuing segmentation of the consumer credit marketplace will likely foster irrational pricing and abuse.

B. *The Finance Charge Forms the Basis for the Disclosure of the Key Cost of Credit, the APR*

The finance charge provides a dollar measure of the total cost of credit. The correct finance charge provides the basis for the calculation of the APR. The APR converts the finance charge into a percentage rate,[77] with the combined total interest and fees charged shown as an annualized percentage of the real benefit obtained from the loan. The APR is the only cost disclosure in the marketplace that allows consumers to comparison shop across categories of credit that vary by term, interest rate, and fees.[78] The more accurate and inclusive the finance charge is, the more accurate the APR. Accurate and meaningful disclosure of the cost of credit is the raison d' être for TILA. Without an accurate APR, the core purpose of TILA collapses.[79]

C. *Effective Disclosure of the APR Reduces Costs*

We commend the Board for its commitment to improving the disclosure of the APR. As the Board has recognized, the APR is the key cost disclosure.[80] The available

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[76] 15 U.S.C. § 1601(a).
[77] 15 U.S.C. § 1606(a).
[78] *Cf.* Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Slight of Hand: Salience Distortion of American Credit Pricing Limits*, 92 Minn. L. Rev. 1110 (Apr. 2008) (using Truth in Lending calculations to demonstrate that the effective cost of credit permitted on payday loans by state usury caps is much higher than appears from the state statutes).
[79] *See* Matthew A. Edwards, *Empirical and Behavioral Critiques of Mandatory Disclosure: Socioeconomics and the Quest for Truth in Lending*, 14 Cornell J.L. & Pub. Pol'y 199, 226 (2005).
[80] 74 Fed. Reg. 43,232, 43,243 (Aug. 26, 2009).

evidence supports the view that effective disclosure of the APR correlates strongly with lower credit prices and increased competition.[81] Without effective disclosure of the APR, consumers cannot themselves reliably determine the tradeoff among monthly payments, fees, and interest. According to the Board's own testing, if the APR is not disclosed effectively, consumers are often misled by lower payments or a lower interest rate to choose a more expensive loan.[82] The APR can, like other common consumer disclosures such as energy star ratings, help consumers focus on the overall cost of the product and not only one or two price components.[83]

The APR is not perfect. The APR does not take into account whether the credit is suitable for the consumer. It does not address the subjective reasons a consumer might prefer one source or type of credit over another. Even if the finance charge included all fees, the APR would still fail to account for all economic costs that arise after a loan's inception in closed-end transactions.[84] Moreover, virtually no consumer can explain how to calculate the APR and most consumers confuse the APR with the interest rate.[85]

Fortunately, consumers do not need to understand the APR to use it; they need only understand that it is the appropriate measure for cost comparison. Consumers neither need nor want all the nuances of true economic pricing in their decision making.[86] In its recent testing, the Board looked extensively at the question of the loan's duration and the impact that a changing duration has on the cost of the loan. But what the test results show is that most consumers do not understand that level of detail and do not care

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[81] *See* Victor Stango & Jonathan Zinman, How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets 3–4 (Sept. 5, 2006) (unpublished manuscript, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928956) (stating that in markets where TILA disclosures are made reliably, consumers who most underestimate APRs given a payment stream do not overpay on credit; in markets where TILA disclosures are not made reliably, same consumers pay 200–400 basis points more for interest compared to consumers who underestimate APRs to a lesser degree). *Cf.* Oren Bar-Gill, *The Law, Economics, and Psychology of Subprime Mortgage Contracts*, 94 Cornell L. Rev. 1073 (2009) (arguing that an improved APR could aid consumer-decision-making and improve competition and pricing in the subprime mortgage market).

[82] *See* ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 47 (2009).

[83] *Cf.* Matthias Deutsch, The Effect of Life-Cycle Cost Disclosure on Consumer Behavior (unpublished Ph.D. dissertation, Univ. of Md., 2007), *available at* http://hdl.handle.net/1903/6794 (finding that shoppers who received "life-cycle cost" information chose cooling appliances and washing machines that used less energy). *See also* Matthias Deutsch, Life-Cycle Cost Disclosure, *Consumer Behavior, and Business Implications: Evidence from an Online Field Experiment*, *in* Sustainable Consumption and Production: Framework for Action 391, 406 (Theo Geer Ken et al. eds., 2008) ("Disclosing estimated life-cycle costs to shoppers makes them opt for washing machines with, on average, 0.83% less specific energy consumption and 0.74% less specific water consumption.").

[84] Examples of post-inception costs include: prepayment penalties, late and over-limit fees, the increase in the rate when the rate can adjust, and the actual versus assumed duration of the loan.

[85] *See, e.g.*, ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 16, 35, 59, 68 (2009); Macro Int'l, Inc., Design and Testing of Effective Truth in Lending Disclosures 47 (2007), *available at* http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf.

[86] *Cf.* Oren Bar-Gill, *The Law, Economics, and Psychology of Subprime Mortgage Contracts*, 94 Cornell L. Rev. 1073 (2009).

about it even when they do understand it. What they do care about, and cannot determine without a comprehensive APR, is the comparative cost of credit.

Evidence indicates that consumers—at least in the prime market—do generally use the APR: More than 70% of the population reports using the APR to shop for closed-end credit;[87] 78% of homeowners who refinanced their homes report comparison shopping on the basis of the APR.[88] It is conceivable that this relatively widespread reliance on the APR could be reduced by too much information. Like energy star ratings for appliances or average miles per gallon, the APR probably works better the simpler and more standard the comparison.

We would encourage the Board to consider some additional testing of the APR disclosure to maximize the effective disclosure of the APR. It appears that the Board did very minimal testing of consumers' ability to use the APR to pick the cheaper loan, and what testing there was suggests that the co-disclosure of the interest rate may overshadow the disclosure of the APR when consumers are trying to pick the cheaper loan.[89] Overshadowing of the APR by the interest rate may happen because borrowers have a better cognitive understanding of interest than APR; when the two are in close proximity, borrowers may use the interest rate as the familiar proxy for cost, not understanding how fees and term also influence the total cost. Since the APR is the key cost disclosure and only cost disclosure that allows consumers to compare loans with different rates, terms, and fees, the Board must ensure that the APR is not overshadowed.

The Board's improved graphic should make comparison shopping within closed-end mortgage loans easier than ever. The result should be to encourage consumers to use the APR—and consequently to demand competitive pricing—for closed-end mortgage loans.

D. *The APR Allows Shopping and Fosters Competition Across Different Categories of Credit*

Consumers may also recognize that the APR is also disclosed for other kinds of both closed- and open-end credit.[90] In some circumstances, these other forms of credit may act as a substitute for closed-end mortgage credit—a parent deciding how to fund a student's education may consider student loans, credit card financing, or an open-end HELOC, as well as a closed-end home equity loan, for example. The more inclusive and consistent the definition of the finance charge, the more possibility the APR has for such comparison shopping. Indeed, the more standardized the APR becomes, the more likely it is that consumers will understand its utility and rely on it appropriately. The overall

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[87] Jinkook Lee & Jeanne M. Hogarth, *The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates*, 18 J. Pub. Pol'y & Marketing 66, 74 (1999).
[88] Jinkook Lee & Jean M. Hogarth, *Consumer Information Search for Home Mortgages: Who, What, How Much, and What Else?*, 9 Fin. Services Rev. 277, 286 (2000).
[89] *See* ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-end Mortgages 64 (2009).
[90] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 27 (2009) (some testing participants recognize the APR from the credit card context).

utility of the APR is undercut if it has one meaning for closed-end mortgage loans, another for non-mortgage closed-end credit, a third for HELOCs, a fourth for credit cards, and so forth.

We applaud the Board's significant progress towards improving the disclosure of the APR—both through the consumer-tested graphic disclosure that situates the APR in context and through the vastly enhanced finance charge definition for closed-end loans. We encourage the Board to continue on this path with the goal of making the finance charge and APR truly comparable across all credit products. Providing consumers with the tools they need to shop comparatively throughout the credit market, not solely within various pre-defined credit niches, could assist in promoting vigorous competition throughout the credit market and thus prevent abuses migrating from one segment to another.

E. *Abuses Are Widespread in Both Mortgage and Non-Mortgage Lending*

Abuses in lending are endemic. The Board in its proposal focuses on abuses in mortgage lending, in part because of the specific charge given it in 15 U.S.C. § 1639(*l*) to address abusive mortgage lending practices. Other commentators have also suggested that reform of the finance charge and APR disclosures could address at least some of the abuse in the subprime mortgage market.[91]

But creditors have taken advantage of weaknesses in the definition of the finance charge and APR in many other aspects of closed-end consumer lending, particularly to low-income, minority, and other vulnerable consumers. For example, in auto-title lending, an all-inclusive APR is often several times the disclosed APR.[92] No one could claim that the financing of auto sales, whether new or used, is untainted. Indeed, fee-packing, credit insurance, and variants of (often undisclosed) yield spread premiums are commonplace in auto financing.[93]

The Board's current proposal largely leaves unreformed the same abusive practices in non-mortgage closed-end lending that it seeks to ferret out of mortgage lending.

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[91] Oren Bar-Gill, *The Law, Economics, and Psychology of Subprime Mortgage Contracts*, 94 Cornell L. Rev. 1073 (2009) (arguing that an improved APR could aid consumer-decision-making and improve competition and pricing in the subprime mortgage market).

[92] Amanda Quester & Jean Ann Fox, Ctr. for Responsible Lending & Consumer Fed'n of Am., Car Title Lending: Driving Borrowers to Financial Ruin 6 (2005), *available at* http://www.responsiblelending.org/pdfs/rr008-Car_Title_Lending-0405.pdf (reporting that reported APRs range from 200% to 300% and actual APRs in states without rate caps routinely reach 800%).

[93] *See generally* John W. Van Alst, National Consumer Law Center, Fueling Fair Practices: A Road Map to Improved Public Policy for Used Car Sales and Financing (2009), *available at* http://www.consumerlaw.org/issues/auto/content/report-fuelingfairpractices0309.pdf.

IV. FINANCE CHARGE DEFINITION: THE BOARD'S PROPOSAL—§ 226.4[94]

A. *Introduction: The Board's Expansion of the Finance Charge Definition Is an Important Step Forward, but Other Steps Are Also Necessary*

The Board's proposal is a dramatic reversal from decades of whittling away at the finance charge. The Board now proposes to largely undo the damage, done by both Congress and the Board, with respect to closed-end mortgage loans. This is a significant step forward in a large segment of the consumer credit market. The Board's tightened treatment of credit insurance and debt cancellation or suspension agreements is also a welcome step forward.

B. *The Broad Definition of the Finance Charge for Closed-End Mortgage Loans Should Be Adopted and Should Not Be Undermined Through Increased Tolerances*

1. Overview

As the Board recognizes, mortgage credit is of single importance to many consumers. For most consumers, their largest asset is put at risk in a mortgage transaction.

Under the Board's proposal, all fees, except seller's points and the cost of recording a deed on a purchase money mortgage, would be included in the finance charge. This bright-line rule should simplify compliance and facilitate comparison. It will eliminate many "gotchas" for unwary lenders, while providing consumers with better information about the cost of their loans. The simple analysis proposed by the Board comports with the economic reality for most consumers: All the fees incurred in a mortgage transaction are a cost of obtaining the credit. The all-in approach should improve economic rationality in mortgage lending: No longer will the disclosed price of a closed-end mortgage loan depend on how a fee is titled, or whether the lender performs the activity in-house or out-sources it.

2. Inclusion of More Loans Under HOEPA (Home Ownership and Equity Protection Act) and State Laws Is Appropriate

The Board notes that the all-in approach is likely to make more loans subject to additional laws and regulations at both the state and federal levels.[95] To the extent this is true, this is a positive outcome. The all-in finance charge, after all, reveals the true cost of the loan. Whether or not a loan should be subject to increased regulation on the basis of its price should depend on as accurate, comprehensive, and comparable determination of its price as possible. Gamesmanship with the APR in order to escape scrutiny under federal or state legislation benefits neither consumers nor honest lenders.

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[94] The Board's proposal regarding the finance charge for HELOCs is discussed at Section II of those comments, reprinted at Appendix I, *infra*.

[95] 74 Fed. Reg. 43,232, 43,244 (Aug. 26, 2009).

Any line separating high-cost and high-risk credit from less risky credit is necessarily arbitrary. The Board's proposal makes the determination of that line less arbitrary—surely a result to be welcomed—and reveals as high-cost those loans that are, in fact, high-cost. The existing lack of clarity in the finance charge definition has allowed many high-cost loans to masquerade as affordable products; the Board's improvement to the finance charge should help increase clarity in the marketplace.

As the Board notes, coverage under the state statutes is, in most instances, not a bar to purchase on the secondary market.[96] Indeed, in many states, the restrictions imposed on loans that trigger the high-cost standard are not significantly more onerous than those the Board imposed on all higher-cost loans in its rulemaking last year.[97]

Estimates of how many new loans will be covered in the event are imprecise at best. Some lenders who are near the thresholds will doubtless shift their costs down lower, just as they did when the state and federal statutes were first enacted. Indeed, in most cases, the creditors affected will be those who have deliberately sought to come as close to threshold as possible—to charge as much as they can while still evading coverage.

Moreover, the Board's proposal is likely to affect pricing in other ways. For example, many state laws include yield spread premiums in their points and fees triggers items.[98] Yield spread premiums are prevalent in the high-cost market and usually result in a higher APR for borrowers, since the interest rate is increased, often without any decrease in total broker compensation.[99] Yield spread premiums would be banned under the Board's proposal.[100] Thus, the new finance charge definition will likely only result in more loans being covered under these states' laws if the "new" finance charges—primarily closing agent fees and taxes, usually in the hundreds of dollars—exceed the amount of existing yield spread premiums—typically in the thousands of dollars—plus any excess interest charged due to the yield spread premium. Furthermore, based on current evidence, one would expect both total mortgage broker compensation and other closing costs to decrease in the absence of yield spread premiums, reducing the finance charge and APR, since both total broker compensation and other closing costs increase when the broker is paid a yield spread premium.[101] As a result, the Board's proposal, taken as a whole, should reduce the number of loans that trigger most state high-cost statutes.

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[96] *Id.*
[97] *See* Truth in Lending, 73 Fed. Reg. 44,522, 44,524 (July 30, 2008).
[98] *See, e.g.,* 815 Ill. Comp. Stat. ch. 815, 137/10.
[99] *See generally* National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses § 11.6.4.2 (4th ed. 2009).
[100] 74 Fed. Reg. 43,232, 43,279 (Aug. 26, 2009).
[101] *See* Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-24 to 2-43 (2008); Susan Woodward, A Study of Closing Costs on FHA Mortgages, U.S. Department of Housing and Urban Development, Office of Policy Development and Research. (2008), *available at* http://www.urban.org/UploadedPDF/411682_fha_mortgages.pdf..

Additionally, the state statutes do not cover all the loans made over the triggers now nor will they in the near future. Most of lenders are exempted from state statutes as federally regulated lenders, and other lenders may in some circumstances claim the protection of state parity laws granting state-regulated lenders protection from state legislation to the same extent as national banks or thrifts. Thus, generalizing from HMDA data disclosure may overstate the number of loans subject to state regulation.

3. Creditors Can and Should Be Encouraged to Fix All Costs Prior to Closing

a. *Introduction*

Consumers do not have a chance to revisit any given mortgage transaction: most shopping terminates at loan application,[102] and virtually no consumers walk away at closing. There is, as the Board recognizes, no process post-closing for remedying billing errors, as there is with open-end credit.[103] Thus, the pre-closing disclosures are of particular importance. Unless borrowers receive accurate, binding, and comparable disclosures substantially in advance of closing, they cannot and will not shop.

In general, there is every reason to believe that lenders can determine costs before closing. Creditors do not need increased tolerances, indexing, or special treatment of "voluntary" third-party charges in order to get the finance charge right. They need the incentive to get the finance charge right. Until and unless there is a hard deadline for disclosure coupled with meaningful consequences for failure to properly disclose, creditors will not be motivated to make the disclosures correctly.

b. *Neither Indexing nor Increased Tolerances Are Appropriate*

The Board requests comment on whether the removal of (almost) all exclusions for third party charges should result in an increased tolerance for error in disclosing the amount of the finance charge, as well as whether the tolerance (either at its current or an increased level) should be indexed for inflation.[104] The Board should not take either measure.

Increased tolerances are unnecessary. Under the new good faith estimate (GFE) rules, creditors will have no tolerance at all for a large range of costs and are confined to a narrow error range for other costs. Thus, early in the process, within three days of application, creditors are already required to fix their costs and determine close estimates of most third-party charges. Moreover, many third-party charges may be average-cost priced, further reducing any possible ambiguity as to the amount of the charge. In this era of computerization and instant document transfer, there is no reason that a creditor cannot know and fix at least three days before a scheduled closing any fee. Existing

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[102] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages, at iii, 6 (2009).
[103] 74 Fed. Reg. 43,232, 43,251 (Aug. 26, 2009).
[104] 74 Fed. Reg. 43,232, 43,246 (Aug. 26, 2009).

tolerances afford an over-generous protection for good faith, unavoidable errors. Increased tolerances would only encourage sloppiness on the part of creditors. Moreover, where a third-party fee unavoidably changes at the last minute, beyond the tolerances, the creditor can already protect itself: it can notify the borrower of the error and reschedule the closing, thus giving the borrower the opportunity to cancel the transaction if the change is material to the borrower.[105] Increasing the tolerances would also undercut the utility of the finance charge and APR disclosures, by rendering them less precise, less comparable, and therefore less meaningful for both creditors and consumers.

None of the basic TILA measurements are indexed to inflation, neither the covered loan amount nor statutory damages.[106] The covered loan amount for non-real-estate secured loans has not increased since 1968, when TILA was enacted; Congress has only minimally increased the statutory damage amount for certain categories of loans. Indexing tolerances when the covered loan amount is not indexed seems perversely creditor-friendly—given enough time, the tolerances could swallow all the finance charges on covered loans.

Indexing also complicates compliance. Determining whether or not a creditor violated the finance charge and APR disclosures will require not just a review of the numbers, but also the date of the closing. Lenders may have an incentive to push closings till after the first of year or to fudge the dates on when a closing happened.

More fundamentally, there is no indication that the value of tolerances has been eroded by inflation. Over recent years, improvements in technology, changes to the RESPA rules, and market consolidation have all increased creditors' control over third-party charges. The need for tolerances in the finance charge has diminished.

Innovations in the mortgage market have reduced and should continue to reduce the need for tolerances. The goal of the Board should be always to promote more, not less, accurate, disclosures. Increased tolerances, whether through indexing or at one-fell swoop, encourage less accurate disclosures and complicate compliance.

c. *Voluntary Charges Can Be Determined Before Closing with Additional Guidance from the Board as to Reasonable Assumptions*

As the Board notes, the most common voluntary third-party charge is credit insurance, for which "creditors generally solicit consumers."[107] There are no common, existing, third-party charges of which we are aware that a creditor could not determine three days in advance—at least not ones that would fit in the basic definition of the finance charge. Creditors will generally have ready access to information about pricing in

[105] Since borrowers can waive the three-day waiting period between corrected disclosures and closing in the case of a bona fide personal emergency, Regulation Z § 226.19(a)(3), consumers will not be seriously harmed by the delay, although they may be annoyed. The Board should not attempt to shield creditors from consumers' annoyance: consumers' annoyance should instead provide creditors with some market incentive to get the disclosures right in a timely way, even if that means checking their numbers in advance.
[106] The points and fees floor for HOEPA loans is an exception. 15 U.S.C. § 1602(aa)(3).
[107] 74 Fed. Reg. 43,232, 43,246 (Aug. 26, 2009).

the required timeframe. Indeed, most creditors will require such information in order to process their wire transfer of funds to the closing company.

Further guidance on the creditor's reasonable assumptions would be helpful. The proposed Official Staff Commentary directs the creditor to make these disclosures "on the best information reasonably available" and permits the creditor to "provide explanatory material concerning the estimates and the contingencies that may affect the actual terms . . . ."[108] This commentary would be strengthened by an illustrative list of information sources that a creditor should consult minimally. The creditor should be required to consult its own records on what other borrowers were charged on similar loans and to pricing information from third-party vendors that the creditor frequently works with of the product the borrower has the option of purchasing.

Absent the creditors' best attempts to provide accurate pricing information, the disclosures should not be treated as accurate.

4. Uniform Treatment of Third-Party Fees Is Appropriate

The Board proposes to cut the Gordian knot of much TILA litigation since the *Rodash v. AIB Mortgage Co.* in 1994.[109] Instead of requiring a case-by-case determination of which fees are in, and which fees are out, a determination that now depends on nearly microscopic analysis of the creditors' instructions to third-party agents, the Board would promote uniformity and consistency in the marketplace by treating virtually all third-party fees as finance charges (property insurance and some taxes for purchase money mortgages would continue to be excluded, as being payable regardless of whether or not the credit was extended or in a comparable cash transaction).

The current approach requires a "case-by-case" analysis for excluding these charges, which fosters confusion and inconsistency.[110] It has also led to an explosion of bizarre third-party fees, including $50 e-mail fees, multiple charges for courier fees, sometimes amounting to hundreds of dollars, and "fax review fees." Consumers typically discover these fees at closing, if at all, when they are often listed among dozens of other fees and relatively small potatoes compared to the total cost of the loan and when there is virtually no meaningful opportunity for the consumer to negotiate the fees down. Since creditors can exclude these fees from the finance charge and consumers, not creditors, bear the cost of these fees, creditors have had no incentive to impose rationality on these fees.

Creating criteria distinct from the basic test—such as those found in Regulation Z § 226.4(a)(2)—will inevitably result in the need for specific factual determinations, with a corresponding cottage industry of litigation and consequent inconsistent results. A blanket exclusion of certain charges (for instance, courier charges paid by closing agents) would not work because there is no category of commonplace third-party charges in

[108] 74 Fed. Reg. 43,232, 43292 (Aug. 26, 2009) (Proposed Official Staff Commentary § 226.19(19)(1)).
[109] 16 F.3d 1142, 1147, 1148 (11th Cir. 1994).
[110] 74 Fed. Reg. 43246.

credit transactions that can be said never to be the result of the creditor's direct or indirect imposition of them. Moreover, any carve-out will encourage either creditors, through affiliate relationships, or third parties, due to reduced oversight by creditors, to use that fee as a new profit center. The Board should not dilute the strength of its new all-in approach by carving out new exclusions from the basic test.

5. Elimination of the Comparable Cash-Transaction for Refinancings Simplifies the Finance Charge Analysis

The Board correctly notes that there is no comparable cash transaction for refinancing. This recognition and the addition of Official Staff Commentary clarifying this issue simplifies dramatically the finance charge analysis for the many closed-end transactions for which there is no comparable cash transaction.

C. *Disclosures Are Enhanced by Inclusion of Credit Insurance and Debt Cancellation or Suspension Premiums in the Finance Charge for Closed-End Mortgage Loans and When the Consumer Will Not Benefit*

1. Treatment for Mortgage Loans

We applaud the Board for its proposal automatically including credit insurance and debt cancellation or suspension premiums[111] in the finance charge for closed-end mortgage transactions. Automatic inclusion of these premiums in the closed-end mortgage context will lead to greater accuracy in terms of the finance charge (and resulting APR) disclosed to consumers, thereby leveling the playing field between consumers and creditors in what has long been an area in which creditors have benefited at the expense of consumers.

In its discussion of whether to treat credit insurance– in non-mortgage transactions—as a finance charge, the Board draws an important distinction between premiums for insurance that provide a benefit to the consumers and insurance with no benefit. Due to the exclusionary rule, the sale of credit insurance has been one way for a creditor to boost its profits while concealing from consumers the true cost of the loan. The Board's proposed change with respect to closed-end transactions will go a long way toward curbing creditor abuses in this area, as creditors will no longer be able to hide the true cost of these products from consumers.

We urge the Board to go further in addressing this problem. There are three additional steps necessary to implement the Board's vision: 1) creditors should be required to do more detailed eligibility screening; 2) the Board's already much improved disclosures of credit insurance should be further refined to provide more useful information to consumers; and 3) the sale of no-benefit credit insurance should be banned.

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[111] Hereinafter, in sections IV & V of these comments, any reference to credit insurance should be understood as encompassing debt cancellation or suspension agreements as well, unless otherwise indicated.

The Board's proposal is a marked improvement in disclosure. But disclosure is not enough. The Board should use its authority under 15 U.S.C. § 1639(*l)* to ban no-benefit insurance in the mortgage context and should clarify that one basis for the inclusion of no-benefit credit insurance in the finance charge is that such a charge is per se not bona fide and reasonable.

2. Eligibility Screening by Creditors in Non-Mortgage Loans Is Essential

a. *Overview*

The Board proposes to require that before a creditor be permitted to exclude premiums for credit insurance from the finance charge for non-mortgage transactions, under new Regulation Z § 226.4(c), the creditor must evaluate the borrower's actual qualifications for the insurance based on age and employment criteria to ascertain whether the borrower meets the qualifying conditions for the insurance.[112] This is an excellent requirement, and we applaud the Board for taking this step.

Under existing law, creditors have every incentive to sell borrowers credit insurance products regardless of the benefit to the consumer. Consumers often have little experience with these products and assume that they function much like regular life or disability insurance policies, when, in fact, the restrictions on credit insurance tend to be narrower even than standard non-credit policies. Moreover, consumers tend to assume that an insurance product sold by the creditor will provide some benefit.[113]

Credit insurance policies provide disproportionate benefits to creditors in at least two ways. First, creditors usually make money from the sale of credit insurance[114] upfront. The commission arrangements which creditors have with third-party sellers of credit insurance encourage them to sell certain products to consumers over others, undermining the extent to which the consumer is able actually to make the voluntary choice required for exclusion under Regulation Z § 226.4(d). Furthermore, creditors typically sell debt cancellation or suspension agreements directly to consumers, thus setting the price—without the state oversight which exists for the sale of credit insurance.

Second, creditors generally stand to receive a greater future benefit than the consumer should the insured-against or agreed-upon condition (such as loss of life or employment) occur, and the consumer can no longer make payments. The creditor receives whatever pay-out there is, and the consumer remains on the hook for any shortage between the debt owed and the amount paid.

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[112] 74 Fed. Reg. 43,232, 43,248 (Aug. 26, 2009).
[113] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 72 (2009).
[114] For this sentence and the rest of this paragraph, we do not use "credit insurance" to refer to debt cancellation and suspension agreements as well.

Creditors have been able to inure all of these benefits to themselves in part due to the lack of any requirement that borrowers benefit from the sale of the insurance. Creditors have been free to sell borrowers useless insurance and exclude this cost from the finance charge.

b. *Borrowers Usually Rely on Creditors to Determine If They Will Benefit from the Credit Insurance*

Consumers who knowingly purchase credit insurance do so because they believe the purchase of insurance is financially prudent.[115] They rely on the promise that if the qualifying event occurs (disability, job loss, death) the credit payments will be covered.

Borrowers implicitly trust their brokers and loan officers, even in the face of attempts to explain that brokers and loan officers do not have borrowers' best interests at heart.[116] Consumers are easily swayed, even by a bland disclosure of the availability of credit insurance, to believe they should purchase it.[117] They assume that their lender would not offer them a product for which they do not qualify.[118] As with many other aspects of a loan transaction, borrowers know that the creditor is in a better position than the consumer to assess the suitability of the financial products offered.

c. *Creditors Are Usually In a Position to Know If the Borrower Will Benefit*

As the Board notes, consumers are "generally" solicited for credit insurance by the creditor.[119] Creditors will generally know or have easy access to what the eligibility requirements are and what the terms of the policy are.

Moreover, creditors will have in their files—assuming they do any underwriting at all—sufficient information to verify many if not all of the eligibility terms. For example, creditors should obtain employment information and routinely ask for a statement from the employer as to the prospects for continued employment. Loan applications ask for a date of birth, as well as age and employment information. Creditors pull credit reports, which usually contain sufficient information to verify age and other eligibility characteristics. Tax returns, another source for verifying eligibility identified by the Board, are routinely requested.

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[115] *See, e.g.*, ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 47 (2009) (upon disclosure of credit life insurance, "several participants commented that credit life insurance sounded like an important loan feature and indicated that they would want to enroll").

[116] *See, e.g.*, 74 Fed. Reg. 44,522, 44,564–44,565 (July 30, 2008) (discussing results of consumer testing of broker compensation conducted under the auspices of the Federal Reserve Board).

[117] *Cf.* ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 47 (2009) (several of the test participants, upon being told of credit life insurance thought it was an important product that should be purchased).

[118] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 72 (2009). *Cf. id.* at 5 (trust is among the "most important considerations" for consumers selecting a lender).

[119] 74 Fed. Reg. 43,232, 43,246 (Aug. 26, 2009).

The Board's proposed guidance sets out a comprehensive list of sources that creditors may use to verify eligibility status with respect to the age and employment criteria.[120] As even a cursory review of this list suggests, creditors already have in their possession ample grounds for determining if a borrower is eligible to benefit from credit life insurance or not.

d. *The Proposed Language in the Commentary Should Be Clarified to Make Explicit the Creditor's Duty to Conduct Eligibility Screening in Closed-End Mortgage Transactions*

Since the Board proposes to include in the finance charge automatically all credit insurance premiums for closed-end mortgage transactions, screening for eligibility is not a pre-requisite for exclusion from the finance charge. As a result, the Board's language is somewhat ambiguous as to whether or not creditors have a duty in the closed-end mortgage context to screen borrowers for eligibility.

The proposed rules for closed-end mortgage transactions require disclosures about age and employment eligibility determinations: either that the consumer is eligible based on age and employment criteria (if those are the product's only criteria) or that the consumer might be eligible based on age and employment criteria but other factors might render the consumer ineligible.[121] The proposed Official Staff Commentary states that these disclosures cannot be made when the consumer does not qualify for the product.[122] The take-away message is that creditors must conduct age and employment eligibility determinations if they are selling credit insurance in connection with closed-end mortgages and that they should not be selling any of these products for which the consumer is not actually eligible. At no point in the proposed rules or Official Staff Commentary is this stated directly. Adding language to this effect at the beginning of the Proposed Official Staff Commentary § 226.28(h)(5)(1) would help ensure compliance with this important new requirement. Creditors should be required to screen borrowers for eligibility for credit insurance, whether or not such screening will or will not determine finance charge status.

3. Eligibility Screening by Creditors Should Be Expanded

a. *Creditors Should Be Required to Tell Borrowers Whether or Not They Are Eligible for the Coverage, Listing All Criteria*

For creditors to exclude purchase of these products from the finance charge, the creditor should be required to determine whether or not the borrower is eligible to the extent that information is reasonably available to the creditor. As the Board has acknowledged, no reasonable consumer would agree to buy a product that is worthless to her or him.[123] For age and employment eligibility criteria, creditors should have enough

[120] 74 Fed. Reg. 43,248, 43,373 (Proposed Official Staff Commentary § 226.4(d)-14)).
[121] 74 Fed. Reg. 43,337 (Proposed Regulation Z §§ 226.38(h)(5) and (6)).
[122] 74 Fed. Reg. 43,417.
[123] *See* 74 Fed. Reg. 43,249.

information in their files to determine eligibility and creditors should be required to make an absolute determination of eligibility.

There may be other critical eligibility requirements that the creditor may or may not know, such as health status. A creditor is unlikely to know a consumer's entire health history, and most consumers would rightly regard such a request by the creditor as invasive, even if not in violation of privacy and fair lending laws. On the other hand, it will sometimes be obvious on the face of the loan application that a borrower is ineligible for credit disability insurance if the borrower is receiving income whose receipt is conditional on disability, Supplemental Security Income or Social Security Disability, for example. In all cases where the creditor knows or has in possession information that the borrower is ineligible, the creditor should be required to advise the borrower that they are ineligible.

If the creditor does not know whether or not the borrower is eligible, the creditor should be required to advise the borrower of all criteria it has not reviewed. The Board's proposed language—that a consumer "'may not qualify to receive any benefits because of other eligibility restrictions'"[124]—is of limited utility. While the proposed disclosure would help alert consumers to the possibility of additional criteria, it does not provide the consumer with the critical information.

Space to list these restrictions on eligibility could be provided in the model clause and form by revising the fourth bullet to read: "However, you may not qualify to receive any benefits because of other eligibility restrictions. For this product, all of the other eligibility restrictions are as follows . . . ."[125] Consumers would then be in a position to seek out the additional information necessary—such as more details about the specific selection criteria and, if necessary, about themselves—to determine whether they will choose *voluntarily* to commit to the particular product. As it stands, the Board's proposed disclosure language is unclear and potentially misleading.

b. *Creditors Should Disclose the Time at Which a Borrower Will No Longer Be Eligible for the Credit Insurance, If the Borrower Will Age Out of the Product's Coverage During the Life of the Loan*

Creditors could protect their substantial profits from selling worthless products and comply with the law by purposefully selling products for which the consumer will no longer be eligible (due to growing older, for instance) after a very short period of time following the sale. Consumers would reasonably believe that if they continue to be charged money for a product, they are getting something of value in return. If they in fact are not, then no reasonable consumer would continue voluntarily to pay for it. If the products allows for the borrower to age out, it is a simple matter of math for the creditor to calculate and disclose to the borrower when they will no longer be eligible for such

[124] 74 Fed. Reg. 43,249.
[125] 74 Fed. Reg. 43,348 (Proposed Appendices G-16(C) & (D), 74 Fed. Reg. 43,338; Proposed Appendices H-17(C) & (D)).

coverage. Such transaction-specific disclosures should increase consumer understanding without information overload and do not impose an excessive burden on the creditor.

c. *Creditors Should Be Required to Review Eligibility During the Life of the Loan and Notify Borrowers If They Are No Longer Eligible*

Creditors should conduct an annual review of the eligibility criteria for the credit insurance product and compare those eligibility criteria with information in the creditor's file. Creditors will certainly have on record the borrower's birth date and so can determine continuing age eligibility restrictions, for example, but the creditor's agents may well have received information that the borrower has become disabled or lost a job. Creditors should have an affirmative obligation to notify the consumer when any event of which the creditor has actual knowledge transpires that renders the consumer ineligible. Becoming too old would likely be the most frequent event of this type.[126]

Absent these protections, creditors will continue to be able to receive value for something (through payment of annual premiums) that ultimately has no value to the consumer, and they will be able to do so without the consumer realizing how much they are paying because the product was not included in the finance charge. Even if there is no annual premium, as is common with many of these products, such notification protects consumers by alerting them to their lack of coverage and affording them the opportunity to obtain coverage elsewhere if coverage is important to them.

Creditors Should Be Required to Provide Written Disclosures and Obtain

4. Written Consent to the Sale of Credit Insurance in All Closed-End Transactions, Without an Exception for Telephone Sales

The Board is requesting comment on its decision not to propose extending the telephone rule to cover the sale of credit insurance in connection with all closed-end transactions. 74 Fed. Reg. 43,251 (Jan. 29, 2009). The telephone rule is due to take effect on July 1, 2010, and at this time is slated to apply only to open-end (not home secured) transactions.[127] *See* 74 Fed. Reg. 52,44 *et seq.* (Jan. 29, 2009). The rule would dispense with the requirement both of written disclosures and written consumer acceptance of the purchase of credit insurance entered into by phone. 74 Fed. Reg. 43,250.

The Board's decision is a sound one. It helps foster circumstances in which consumers are being sold products that will actually have value to them, and it does not harm creditors. Creditors suffer no meaningful delay in closed-end transactions without the telephone rule, since most sales of credit insurance in closed-end transactions are contemporaneous with the initial closing. There is no hardship for closed-end creditors by not being able to use the phone to sell these products without providing written disclosures because they generally will be providing borrowers all the disclosures in person, at the same time the credit is sold.

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[126] *See* 74 Fed. Reg. 43,249.

[127] In addition, the Board has proposed to apply it to HELOCs. 74 Fed. Reg. 43,439.

The need for pre-sale written disclosures holds true even if the product is sold via the telephone, after the initial closing. As the Board notes, unlike open-end credit there is no low-cost process in closed-end credit for correcting billing errors or resolving disputes as to whether additional "voluntary" products were, in fact, desired.[128] Thus, disclosure before sale is of paramount importance.

Not allowing the telephone rule for any closed-end transactions is good for consumers and, at the very least, no burden for creditors.

5. Disclosure of Credit Insurance Should Include Concrete and Specific Disclosure of the Costs and Benefits of the Proposed Credit Insurance

Unsurprisingly, the borrowers in the study conducted for the Board were emphatic in their preference for loan-specific disclosures.[129] There is no reason not to require creditors to provide loan specific information as to the actual benefit that could be provided to the borrower.

The Board's proposed language —that "[b]ased on our review of your age and/or employment status at this time, you [would][may] be eligible to receive benefits"—does not provide sufficient loan specific information. First, the non-disclosure of ineligibility (since creditors may not use this disclosure if borrowers are not eligible) conceals from borrowers important information. As the Board's testing shows, most borrowers are surprised to learn that their creditor may sell them a product that provides no benefit.[130] Even if the cost is included in the finance charge as non-voluntary, consumers should still be told that the product will not benefit them so that they do not mistakenly rely on the presence of insurance. Second, the language downplays the risk of future ineligibility because it could be read simply as a statement of fact (saying that the creditor has, *at this time*, conducted an eligibility review) rather than as also containing a built-in warning (implying that eligibility might change *at a future time*).

The language should be revised to convey to borrowers more concrete and loan specific information. Without proper consumer understanding of these restrictions, both at the time of the sale of the product and in the future, consumers' purchase of these products cannot be said to be truly voluntary. The Board should conduct further testing in this area to determine the sweet spot in the tradeoff between information overload and provision of useful, specific information. Ideally, borrower would know, before their purchase of credit insurance, whether they currently actually met the eligibility requirements and what circumstances would cause them to lose eligibility for the product in the future. Telling a borrower that she "may" receive no benefit is a useful warning,

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[128] 74 Fed. Reg. 43,251.

[129] *See, e.g.*, Macromedia at 17 (focus group participants discussing variable rate disclosures indicate that disclosure of actual interest rate is more important than more general information contained in ARM loan program disclosures).

[130] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 72 (2009).

but does not provide enough information to aid in rational decision-making. Indeed, many borrowers in the Board's testing who understood that they might receive no benefit drew inappropriately narrow conclusions as to why they might receive no benefit. For example, borrowers presumably drew analogies to regular life insurance in assuming they would lose the benefit of credit life insurance if they committed suicide, but no borrower understood they could age out of eligibility.[131]

6. Inclusion of the Cost of No-Benefit Credit Insurance in the Finance Charge Is No Substitute for Substantive Regulation of Credit Insurance

a. *Overview*

Disclosure is not a substitute for substantive regulation. Fundamentally, borrowers receive no benefit from no-benefit credit insurance. That is why by definition it makes sense to include it in the finance charge as a per se cost of credit. But the sale of no-benefit credit insurance harms consumers in ways that simply raising the interest rate or charging a higher origination fee does not. Borrowers may rely on the credit insurance, even with a disclosure that it may be of no benefit to them. Conceivably, borrowers may even cancel other policies they own. Thus, the harm done by the sale of no-benefit credit insurance is qualitatively different from the harm done by fee packing in general.

Nor can we be confident that the Board's proposed disclosure—that consumers "may" not benefit from the proposed credit insurance—will be focused on or understood even if the consumers focus on the credit insurance. Credit insurance is a relatively small piece of a large, complex transaction. Few consumers are likely to walk away from a transaction simply because of credit insurance. Nor will many consumers focus on the credit insurance disclosures in the context of their overall loan.

The Board is right to include no-benefit credit insurance in the finance charge. It should also make clear that such credit insurance is not bona fide and reasonable.

b. *Consumers Do Not Understand the Concept of No-Benefit Credit Insurance*

The Board has engaged in extensive testing of the credit insurance disclosures. In early testing, many of the test participants, when told of credit insurance, indicated that "credit life insurance sounded like an important feature and . . . they would want to enroll."[132] Even when it was disclosed that the insurance might provide no benefit, most participants did not realize that fact and nearly half expressed a desire to sign up.[133] In a final iteration of the proposed disclosure, participants were told that "Even if you pay for

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[131] *Id.*

[132] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 47 (2009).

[133] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-end Mortgages 64 (2009).

this insurance, you may not qualify to receive any benefits in the future."[134] As Macromedia reported, "[m]ost participants were surprised by [this] statement . . . . A few indicated they did not understand how they could pay for the coverage and then receive no benefits."[135] Nearly one-third (two out of nine) of the participants believed that the insurance would pay off their loan if they died, despite this crystal clear warning. Even those who understood it might not pay off did not realize they might be ineligible from the beginning due to age; they believed their estate would be ineligible if they committed suicide or had a pre-existing medical condition. Thus, they might well be likely to discount the risk of purchasing such insurance. One participant indicated a desire to purchase credit insurance despite the warning.[136]

Despite repeated refinements in the testing, a significant fraction of potential borrowers—and relatively sophisticated borrowers as well, since all were able to give a "thoughtful, articulate answer" to the question of how to find a mortgage loan[137]—continued to underestimate the downside of credit insurance. This result is likely to be worse in the real world, where loan officers have incentives to present credit insurance in the best possible light and consumers are focused on the actual loan rather than the hypothetical disclosures. Disclosure that the product may provide no benefit will not keep borrowers from paying for it and perhaps even relying on it mistakenly.

c. *Creditors May Use Disclosure to Immunize Themselves from Suit*

The Board's silence on the legality of the sale of no-benefit credit insurance creates a potentially dangerous implication—that by describing how to categorize premiums for no-benefit credit insurance, the Board is validating or authorizing such sales.

Selling credit insurance to someone who cannot benefit from the insurance is unfair. Indeed, in many cases, the courts have so held.[138] Yet many state unfair and deceptive act and practices statutes exempt behavior that is authorized by TILA. The Board's silence in this area could be construed as immunizing creditors from suit under these statutes. The Board should not implicitly endorse the sale of a product to a consumer which will be of no value whatsoever to that consumer.

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[134] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages [Last Page (unnumbered)] (2009).
[135] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 72 (2009).
[136] *Id.*
[137] *See* ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages, Appendix B, at 2 (2009).
[138] See extensive discussion on post-claim underwriting and ineligibility in NCLC's The Cost of Credit § 8.5.5.1 (4th ed. 2009).

d. *The Board Should Outlaw No-Benefit Credit Insurance*

The Board has the authority to ban the sale of no-benefit mortgage insurance under 15 U.S.C. § 1639(*l)* for mortgage loans. The Board should exercise its authority to do so.

For non-mortgage loans, the Board should minimize the possibility that its correct proscription for disclosure of no-benefit credit insurance be taken as a blessing on selling consumers products from which they can receive no benefit. The Board could do this by adopting in the Official Staff Commentary language explaining that no-benefit credit insurance is a per se finance charge because the charge is neither for a bona fide product or service nor is it reasonable, since the insurance has no value to the consumer. This clarification will ensure that the Board does not indirectly shield the charging of premiums for no-benefit insurance from legal attack under state unfair and deceptive or unconscionability challenges.

If the Board takes these actions relating to no-benefit credit insurance, creditors will not be able to argue that they are legal based on the Board's explicit requirement for disclosure. As a result consumers will be actually protected from these policies.

V. FINANCE CHARGE DEFINITION: EXTENDING THE BOARD'S INCLUSIVE APPROACH—§ 226.4[139]

A. *Seller's Points Should Be Included in the Finance Charge When the Cost Is Passed onto the Borrower*

Under the Board's proposal, seller's points are the one large remaining loophole in the finance charge definition for closed-end mortgages. Points in general are a per se example of the finance charge.[140] The analytical difficulty with seller's points is whether or not the consumer pays the points directly or indirectly. When the seller passes on the cost to the consumer, seller's points are analytically and practically no different than points paid directly by the consumer, which are a per se finance charge. Under the exception, these points are never part of the finance charge, even when the seller increases the overall price the consumer must pay in a quid pro quo. The Board's blanket exclusion of seller's points assumes that in the majority of cases sellers do not pass on the cost of points to borrowers.

This assumption seems factually wrong. In most cases, sellers will demand a higher price to offset the cost of points. Already there is reason to believe that, in cases of vertical integration, sellers, closing agents, and financers may provide cross subsidization—jacking up the price where it is least likely to be noticed by a borrower while luring a borrower in with artificially low prices in other settings. If seller's points

[139] The Board's proposal regarding the finance charge for HELOCs is discussed at Section II of those comments, reprinted at Appendix I, *infra*.
[140] 15 U.S.C. § 1605(a)(1).

become the singular exception to the finance charge for closed-end mortgages, pricing distortions involving seller's points will surely increase.

The Board should consider either creating a per se rule, such as it has proposed for third-party charges for closed-end mortgages, that sellers' points are per se finance charges. Rare indeed will be the circumstance when the seller does not receive compensation in some form for paying the points. Such a blanket rule would avoid the problems of case-by-case analysis. Failing that, the Board could simply return to the basic finance charge definition—that points are a classic example of the finance charge so long as they are paid directly or indirectly by the consumer. This leaves creditors to determine whether or not the borrower paid the points indirectly. Creditors already require an appraisal and a copy of the sales contract. Often, these two pieces of information will indicate whether or not the sales price was increased in exchange for the seller's payment of points.

B. *The Board Should Use Its § 1604(a) Authority to Remove Statutory Finance Charge Exclusions for Non-Mortgage Loans As Well*

1. General

For the APR to have maximum utility, it should allow consumers to choose between types of credit—closed- versus open-end, secured versus non-secured, car-secured versus home-secured—as well as within categories. The Board has authority under 15 U.S.C. § 1604(a) to make such adjustments via regulation as it deems necessary in order to "effectuate" TILA's purposes and "prevent circumvention or evasion thereof." Allowing the APR to mean different things for different kinds of loans will permit creditors to accelerate the trend exemplified by the explosion of fully drawn HELOCs as second-liens to push borrowers into products with less disclosure. The result is nothing less than an evasion of the purposes of TILA and an end-run around the Board's laudable efforts to reform the existing lax disclosure regime.

Many commentators have criticized the Board for its delay in acting under its 15 U.S.C. § 1639(*l*) authority. The Board should not allow another wave of abusive lending to crest before it provides for an all-in finance charge and APR throughout the credit marketplace. Nothing in history suggests that abuses are confined to mortgage lending; nothing in the Board's analysis suggests that an all-in finance charge would lack justification outside of closed-end mortgage lending.

2. All Third Party Charges Should Be Subject to the Basic Finance Charge Definition

Consumers may incur third-party charges for non-mortgage closed-end lending. Third-party charges are particularly common in car lending, where they have been a source of much fee-padding and litigation. Including all third-party fees in the finance charge would simplify compliance and provide comparability.

3. All Taxes Imposed in a Credit Transaction, Whether Imposed on a Creditor or Consumer, Should Be Included in the Finance Charge

The only taxes that should be excluded from the finance charge are those that would be imposed in a comparable cash transaction—transfer taxes or registration fees, for example. Otherwise, the Board's logic—simplicity and comparability—suggests that treatment of taxes should not depend on whether state law imposes the fee on the creditor or the consumer in the first order. Nor is there any principled reason to treat taxes incurred in perfecting security interests on homes different from taxes incurred in perfecting security interests on cars, for example.

The Board should also consider deleting Comment 226.4(a)-5. At the least, the Board clarify in the comment the relationship between that comment and the Proposed Regulation Z § 226.4(g).

4. Credit Insurance Should Be Included in the Finance Charge: The Board's Analysis for Mortgage Loans Holds for Non-Mortgage Loans

The abuses of credit insurance have not been confined to mortgage lending. Given the potential profit to creditors and the lack often of meaningful opportunity to shop for other providers, the Board should include all payments for credit insurance or debt cancellation or suspension agreements in the finance charge. Credit insurance is fundamentally a product designed to benefit creditors, not consumers. Including it in the finance charge recognizes that economic reality, as well as providing comparability across credit products.

C. *Property Insurance Should Be Included in the Finance Charge in Appropriate Circumstances*

1. Introduction

The Board proposes retaining the current exclusion for property insurance premiums set forth at Regulation Z § 226.4(d)(2) for closed-end mortgages. The Board should consider inclusion of property insurance in the finance charge where it insures only the creditor's interest, not the borrower's. In addition to force placed insurance, the sale of regular property insurance may be a profit center for some creditors.[141] Particularly in markets with high concentrations of communities of color, high-cost lenders often couple the sale of insurance with their lending operations.

[141] National Consumer Law Center, Truth In Lending § 3.9.4.6.1 (6th ed. 2007 & 2009 Supp.).

2. Property Insurance May Also Provide No Benefit to the Borrower and Should Therefore Be Subject to the Same Rules As Credit Life and Disability Insurance

As the Board notes, "creditors generally require such [property] insurance as a condition of extending closed-end credit secured by real property or a dwelling . . . ."[142] Thus, property insurance may meet the basic definition of the finance charge, as a cost imposed by the creditor incident to the credit extension. Significant for the Board is that "consumers who do not have mortgages regularly purchase this type of insurance to protect themselves" from risks of "loss of or damage to the property."[143] The Board is correct in that many property insurance plans purchased in connection with a mortgage offer at least some protection to the consumer. But not all of them do.

By definition, single interest insurance protects the creditor's interest only. And even those property policies that actually are a "hybrid product,"[144] protecting both the consumer and the creditor typically offer the creditor—as loss payee—more protection. When the required property insurance policy protects the creditor but not the consumer, it is essentially the equivalent of mortgage insurance. The creditor is requiring, as a condition of extending credit, that the consumer provide protection of the collateral securing the transaction. This type of situation falls squarely within the basic statutory definition of the finance charge.

The Board should limit the property insurance exclusion to those situations in which the consumer as well as the creditor receives some benefit from the property insurance. While it may not be possible to segregate the portion of the charge that protects the creditor's interest versus the borrowers (although it sometimes is possible),[145] it is possible to determine whether a policy provides protection for both the creditor and the consumer. If the consumer receives no protection under the policy, the property insurance exclusion should not apply. If the consumer receives protection, the exclusion could apply. The specific issue of flood insurance, upon which the Board has requested comment, would be well addressed as part of this new general approach without the need for a separate rule.[146] This change would be consistent with the "all-in" approach,[147] as well as with the Board's rationale for the property exclusion, because it would limit the exclusion to those situations in which property insurance truly is a hybrid product rather than a form of mortgage insurance in disguise.

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[142] 74 Fed. Reg. 43,250.
[143] 74 Fed. Reg. 43,232, 43,250 (Aug. 26, 2009).
[144] 74 Fed. Reg. 43,250.
[145] Indeed, the Official Staff Commentary currently requires disaggregation of coverage and premiums under certain comprehensive property insurance policies with components not being eligible for exclusion under the finance charge. Official Staff Commentary § 226.4(d)(10).
[146] Many, if not most, flood insurance policies would remain eligible for the exclusion, as federal law requires flood insurance for properties in high risk flood zones. *See* www.FloodSmart.gov.
[147] As part of its broader suggestion that the Board adopt the "all in" approach for closed-end non-mortgage transactions and HELOCs, we would ask the Board to make the same changes to the property insurance premium exclusion for these categories of transactions as it is requesting for closed-end mortgage transactions.

3. The Board Should Conduct Testing to Ensure That Consumers Understand That They Need Not Purchase Property Insurance from or Through the Creditor, When the Creditor Offers Such Insurance, to Ensure That the Purchase of Such Insurance Is Voluntary

The changes around the treatment of property insurance that the Board has proposed[148] to ensure that property insurance purchases through creditors are subject to the same disclosures around the "premium or charge and term (if less than the term of the obligation)" as purchases made from the creditor and defining "from or through" as covering both the creditor and the creditor's "affiliate" within the meaning of the Bank Holding Company Act, 12 U.S.C. § 1841(k) are both good and necessary.

The Board should go further and make sure that consumers understand the voluntary nature of the purchase through the creditor and the very real possibility that such insurance will not provide them as much coverage as they could obtain elsewhere at a lower price. As the Board's testing on the credit insurance disclosures demonstrates, this disjunction between creditors' interests and consumers' is not easily conveyed to consumers. First-time home buyers may be particularly unlikely to understand that they have a meaningful choice and that their interests would be served best by shopping elsewhere for insurance. And even more seasoned homeowners may not pay sufficient attention to property insurance when in the midst of the larger refinancing transaction.

D. *The Board Should Remove the § 226.4(c)(7) Exceptions Entirely*

1. Overview

The Board is proposing to remove the Regulation Z § 226.4(c)(7) exclusions for closed-end mortgage transactions. 74 Fed. Reg. 43,247. Removal of this exclusion is vital to the success of the all-in approach. Much of the litigation involving TILA violations and mortgage loans has focused on the Regulation Z § 226.4(c)(7) exclusions, with inconsistent results. The Board's bright-line inclusion of all real-estate related fees should dramatically simplify compliance and lower litigation costs, as well as provide consumers with better and more comparable pricing information.

The Board should go one step further and delete the section entirely. With the Regulation Z § 226.4(c)(7) exclusions applying only to HELOCs, retention of § 226.4(c)(7) is likely only to create confusion.

2. The § 226.4(c)(7) Exclusion No Longer Serves Any Purpose

By their terms, the Regulation Z § 226.4(c)(7) exclusions apply only to real-estate secured loans. With these exclusions no longer applying to closed-end loans, only HELOCs are covered. For the purposes of closed-end credit, then, it would be simplest to delete Regulation Z § 226.4(c)(7).

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[148] *See* 74 Fed. Reg. 43,250, 43,372.

The question is whether the retention of Regulation Z § 226.4(c)(7) serves any purpose for HELOCs. The Board is also proposing a major overhaul of how the cost of credit is disclosed for HELOCs. We discuss the Board's proposal in detail in our comments on the HELOC proposal; for our purposes now it is sufficient to note that it is not clear what meaning, if any, the Regulation Z § 226.4(c)(7) will retain under the Board's proposal for HELOCs. In any event, the reasons the Board advances for an all-in finance charge for closed-end mortgage loan apply with equal force to HELOCs. Thus, from a principled vantage point, the Regulation Z § 226.4(c)(7) exclusions should be deleted.

3. Retention of § 226.4(c)(7) Likely to Be Confusing

At the least, the removal of closed-end loans from coverage under Regulation Z § 226.4(c)(7) suggests that § 226.4(c)(7) should be re-titled to make clear the extent of its coverage. Retention without clarification will certainly confuse at least some compliance officers, counsel for homeowners, and likely judges as well.

More fundamentally, the creation of separate categories of the finance charge for separate loan products is inherently confusing. For the finance charge and APR to be useful, disclosures should be comparable across loan categories. In particular, disclosures for HELOCs and closed-end mortgages loans should be comparable, since consumers often choose between these two forms of credit. Thus, the definition of the finance charge should be the same, to the extent possible. There is no principled basis for treating closing costs as finance charges for the HELOCs and not as finance charges for closed-end mortgage loans. Asking creditors to make these distinctions without a difference invites litigation with uncertain and uneven results.

VI. EARLY DISCLOSURES—§ 226.19[149]

A. *Introduction to Pre-Consummation Final Disclosures and Corrections When Terms Change; Waiver of the Final or Corrected Disclosures Not Appropriate*

Pursuant to recent changes required by the Mortgage Disclosure Improvement Act (MDIA), 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 the consumer's credit history. If changes in the APR on the early TILA disclosure exceeds the prescribed tolerance before consummation, the creditor is required to provide corrected disclosures 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 Board proposes to make several significant changes in these requirements. First, it proposes to expand the types of loans subject to the early disclosure requirement.

[149] Early and Account Opening Disclosures for HELOCs are discussed in Section III of those comments, reprinted at Appendix I, *infra*.

Second, it proposes to require creditors to provide a final TILA disclosure that the consumer must receive at least three business days before consummation, even if no terms have changed since the early TILA disclosure was provided.

Third, the Board proposes to require additional corrected disclosures three business days before closing in certain circumstances. The Board has proposed two alternate triggers for this requirement. Under the first alternative, which we support, corrected disclosures would be required if any loan terms or settlement charges change. Under the second alternative, corrected disclosures would be required only if the APR changes beyond a tolerance or the creditor adds an adjustable-rate feature; the consumer would learn of any other change only when the final disclosures were provided at closing.

The Board is proposing apply its current waiver rule regarding early disclosures to the proposed disclosure regime, thus allowing for waiver of each waiting period.

We urge the Board to adopt its proposed expansion of loans subject to early disclosure requirements, and its proposal to require final disclosures in all cases. Regarding corrected disclosures, the Board should adopt Alternative 1, which requires corrected disclosures if any loan terms change. The Board should prohibit waiver of the requirements for final disclosures and corrected disclosures three days before closing, or, at a minimum, should narrow its waiver rules.

B. *The Board's Expansion of the Early Disclosure Rules to All Transactions Secured by Real Property or a Dwelling is Appropriate*

The Board proposes to expand Regulation Z § 226.19(a) so that early disclosures are required for all transactions secured by real property, even if the property is not a dwelling and even if the transaction is not subject to RESPA (other than timeshares, which are treated differently under § 226.19(a)(5)). This would extend early disclosures to homeowners financing vacant land and construction loans (although not to loans outside of TILA, such as those primarily for business, commercial or agricultural purposes).

The Board should adopt this proposal. All consumers need access to early disclosures. Early disclosures allow consumers to shop and therefore require creditors to compete in the marketplace. Real estate loans for personal purposes, even where the purchase is of vacant land or for a construction loan, should be covered. Streamlined procedures for creditors will result in lower costs to all parties affected. As the Board notes, applying the early disclosure requirement to all loans would simplify creditors' determination of the time by which creditors must make closed end disclosures.

C. *The Board's Proposal to Require Final Disclosures Three Days Before Consummation Is an Excellent Innovation That Should Be Adopted*

1. Requiring Final Disclosures Three Days Before Closing Will Significantly Improve the Marketplace

The Board proposes that in all cases the consumer must receive final disclosures no later than three business days before consummation, whether or not any of the terms disclosed in the good faith estimate have changed. This is an excellent and insightful proposal that has the potential to accomplish significant improvements in the marketplace.

Currently, Regulation Z § 226.17(b) and Official Staff Commentary § 226.17(b)-1 merely require creditors to make final closed end disclosures before consummation of the transaction. The universal practice is to give final disclosures only when the consumer arrives at the closing. The Board is correct in its perception that creditors have exploited the weaknesses in this disclosure regime to undermine consumers' ability to protect themselves.

The Board cites "long-standing concerns about consumers facing different loan terms or increased settlement costs at closing," expressed by "[m]embers of the Board's Consumer Advisory Council, participants in public hearings, and commenters on prior Board rulemakings." 74 Fed. Reg. 43,259. Our own experience representing consumers and working with consumer attorneys around the country confirms that this problem has been widespread. Indeed, the Board's own consumer testing verified that "consumers are often surprised at closing by changes in important loan terms, such as the addition of an adjustable rate feature." *Id.* Yet, borrowers proceed with the closing, the Board notes, because they lack alternatives or are told they can easily refinance later on better terms after making some payments. *Id.* Lack of notice regarding loan term changes results in a failure to provide a meaningful opportunity to make an informed choice.

The "bait and switch" approach to selling mortgages has been a rampant problem in the subprime and alt-A markets for many years.[150] The Board identified this problem as early as 1998, in its joint report with HUD.[151]

A rule requiring disclosures three days prior to consummation would provide more certainty in the process and would protect consumers from bait and switch attempts regarding the loan terms. It would enable consumers to evaluate loan terms before arriving at closing. It would make effective pre-transaction counseling a realistic

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[150] *See* National Consumer Law Center, Unfair and Deceptive Acts and Practices § 6.6.1, nn.160–166, 169 (7th ed. 2008).

[151] Board of Governors of the Federal Reserve System & Department of Housing & Urban Development, *Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act* 55 (July 1998) (citing Consumers Union, *Dirty Deeds: Abuses and Fraudulent Practices in California's Home Equity Market* (1995)).

possibility, as counselors would know what loan terms the consumer was actually going to be given at closing.

In addition, under such a rule homeowners would have greater notice regarding settlement costs, many of which are included in Truth in Lending calculations. Now, homeowners are unable to shop for settlement services. In fact, settlement service providers do not expect homeowners to shop around.

2. If Creditors Are Required to Finalize Settlement Costs Three Days Before Closing, They Will Find Ways to Do So Without Significant Cost

The Board states that finalizing settlement costs three days before closing "would require significant changes to current settlement practices" that "would generate costs that creditors and third-party service providers would pass on to consumers." 74 Fed. Reg. at 43,260. The Board solicits comment on the operational and other practical effects of this change. In our view, the Board should give little weight to these concerns. Settlement costs change until the last minute because they can. Creditors generally have close relationships with third party service providers; the settlement service providers are repeat players. Yet, without a waiting period rule, it will be a competitive disadvantage to provide early disclosures exactly because it would make that provider more vulnerable to informed shoppers or homeowners who have had time to consider whether the prices are appropriate. Only a uniform rule will shed sunshine on key information in advance of consummation.

Three days is a reasonable and minimal amount of time for settlement service providers to finalize costs. The inconvenience and business costs are small, yet without several days of advance notice homeowners are denied any opportunity to make a meaningful choice about these terms. Further support for the notion that settlement service providers can and should provide firm prices three days in advance of closing is evident in H.R. 4229, recently introduced by Representative Bean and supported by the American Land Title Association. The bill requires such advance notice for settlement statements in all cases under RESPA.

3. The Board Should Consider Requiring Creditors to Highlight Loan Changes in the Final Disclosures

The Board should consider requiring creditors to highlight any loan terms that change between the good faith estimate and the final disclosures. While the new information should not overshadow other key aspects of the disclosure, some way of identifying the new information undoubtedly would be helpful to consumers.

There are a number of possible ways to highlight the loan terms that have changed. They could be printed in a different or bold typeface, or in a different color. Or the creditor could be required to list the changes in a cover letter. We urge the Board to conduct consumer testing to determine the best means of achieving this goal. The Board may be able to draw from how change of terms notices are done in open end credit.

D. *The Board Should Adopt Alternative 1 and Require Corrected Disclosures Whenever Any Terms Change*

The Board's innovative and insightful proposal to require final disclosures three days before closing in all cases would be of little use to consumers if the creditor could change those disclosures before closing. Then the "final" disclosures would not be final at all, but could function as just one more part of a bait-and-switch scheme.

To address this problem, the Board proposes two alternative requirements concerning corrections to the final disclosures. In each alternative, an additional three day waiting period would be triggered if corrected disclosures are provided after the final disclosures are made. In Alternative 1, redisclosure is required if any terms stated in the final disclosures change. In Alternative 2, redisclosure would be required only if the APR changes beyond specified tolerances or if a variable rate feature is added.

As the Board notes, Alternative 1 ensures that consumers are aware of all final loan terms and costs at least three business days before consummation. The Board should adopt this approach. The primary effect of Alternative 1 would be that loan and settlement costs generally would be finalized upon the final disclosure three days prior to consummation.

This reform would be of great benefit to consumers. It would be far better than the current system, under which borrowers usually see changed terms for the first time at closing, when their options—and even their opportunity to read the loan documents—are extremely limited. Alternative 1 would, for the first time, make pre-closing housing counseling a realistic possibility. It would provide a significant deterrence to bait and switch tactics. We strongly urge the Board to adopt Alternative 1.

Alternative 2 is significantly weaker than Alternative 1. While some settlement costs also would be finalized in advance under Alternative 2, some important costs would not. Even worse, many highly important loan terms—terms that the creditor can easily fix three days prior to closing—would not be fixed. Creditors could spring highly risky loan terms on consumers at closing. Creditors and brokers would be able to engage in a revived and dangerous form of bait and switch. If the Board adopts Alternative 2, it can expect the market to take advantage of its weaknesses, switching terms at closing to the full extent of the gaps in the rule.

The Board appears to be offering Alternative 2 in the view that creditors will find it easier to comply with than Alternative 1. We question this assumption. For APR changes, both Alternative 1 and Alternative 2 trigger redisclosure only when the change exceeds a tolerance. The main difference between the proposals is that Alternative 1 requires redisclosure when any other loan term changes. Unlike third-party settlement costs and other components of the APR, which may change slightly at the last minute for legitimate reasons, there is no reason at all for a creditor to change another loan term such

as a prepayment penalty or negative amortization. These can and must be fixed in advance.

If the Board nonetheless adopts Alternative 2, it must be strengthened by requiring redisclosure and a new three-day waiting period for changes in a significantly larger number of loan terms. The Board should require redisclosure not just for addition of a variable rate feature, but also for:

- Addition of a prepayment penalty;
- Negative amortization;
- A change that results in any interest-only payments;
- Addition of a balloon payment;
- Addition of a payment option feature;
- Addition of a demand feature;
- A change in the term of the loan (e.g., from a 30-year to a 40-year term);
- Addition of a shared equity or shared appreciation feature;
- Addition of a required deposit or advance payments.[152]

These loan terms significantly affect affordability and risk to the homeowner. Allowing creditors to change them at the last minute and inform consumers only at closing allows excessive risk to be surreptitiously loaded into the mortgage market. Prepayment penalties drastically limit refinancing options and enable creditors to lock consumers into bad loans. Negative amortization and interest-only provisions create a huge risk of default when the consumer's monthly payments ultimately increase to an amortizing amount. They also limit a homeowner's ability to accrue equity, and to homes for which the debt exceeds the equity. The other loan terms listed are equally dangerous. There is no excuse not to fix these terms three days before closing.

Inclusion of these provisions in Alternative 2 is especially important in light of the Board's proposal to allow waiver of corrected disclosure waiting periods. Consumers need information regarding these changes, and need a time after to consider or shop for other options.

Even with these additions, the limits to this expanded approach under Alternative 2 are demonstrated by the list itself. The next round of loan term abuses are not yet known and if they are not adequately reflected in the APR, which would be redisclosed if material changes were made, they would not be covered even by a broader Alternative 2. Alternative 1 is a far stronger and preferable approach and will ensure that key terms are disclosed in advance. The market can adjust itself to ensure that relatively minor changes to the loan and settlement terms are made prior to the final disclosures three days before consummation, so that redisclosure is not necessary in most circumstances. This is a

[152] Regardless of whether the loan falls within the scope of HOEPA. Advance payments are defined as "[a] payment schedule that consolidates more than two periodic payments and pays them in advance from the proceeds." Regulation Z § 226.32(d)(3).

modest change and a small price to pay to ensure that new bait-and-switch abuses do not emerge.

E. *Waiver of Redisclosure and Corrected Disclosures Should Not Be Permitted; Any Waiver Provision Should Be Extremely Narrow*

1. The Board Should Not Allow Any Waiver of the Three-Day Final Disclosure and Redisclosure Requirements

a. *Allowing Waiver of the Three-Day Final Disclosure and Redisclosure Requirements Will Undermine the Board's Innovative Proposal*

In 2008, when it adopted rules to implement MDIA, the Board included a provision allowing waiver of the seven-day rule (the requirement that a good faith estimate be provided at least seven days before closing) and the three-day rule (the requirement of redisclosure three days before closing if the GFE's APR becomes inaccurate). The Board is proposing to retain this waiver provision without significant change. Under the Board's proposal, the waiver provision would apply to: 1) the seven-day rule; 2) the requirement that the consumer receive the final disclosures three days before closing; and 3) the requirement of redisclosure and a new three-day waiting period in the event the final disclosures become inaccurate. Proposed Regulation Z § 226.19(a)(3).

We oppose the Board's decision to allow waiver of the three-day disclosure requirements. As developed fully in our comments submitted in the MDIA proceeding, allowing the creditor to obtain a waiver from the consumer of this disclosure requirement invites bait and switch tactics.[153] It opens up opportunities for creditors to game the system. It invites creditors to take advantage of consumers who are in difficult circumstances—just the consumers who most need protection. The Board's decision to allow this protection to be waived is particularly unfortunate since the urgency of a consumer's financial need is often within the creditor's control. A creditor can manufacture urgency simply by delaying closing until the consumer has no flexibility and no remaining alternatives. Foreclosure rescue scammers use exactly this technique.

The Board's proposal to require final disclosures in all cases three days before closing, and to require redisclosure whenever all or certain key disclosures become inaccurate, is an excellent one that could have a significant effect on mortgage lending abuses. Allowing waiver will undermine these potential benefits. We urge the Board to revise Proposed Regulation Z § 226.19(a)(3) to eliminate the provision for waiver of the three-day waiting periods.

[153] Failure to provide translated disclosures to non-English speakers also invites bait and switch tactics. As discussed at Section XII(C), the Board should use its rule-making authority to require translated disclosures in certain situations.

b. ***It is Unwise and Unnecessary to Allow Waiver of the Three-Day Final and Redisclosure Requirements: The Three-Day Periods Are Particularly Important for Consumers Who Are Facing Financial Emergencies***

There are two three-day waiting period requirements in the proposed rule. One occurs after the final disclosures are provided (in all circumstances). The second occurs if the creditor changes the terms of the offered loan (or just the APR or a fixed-rate feature in Alternative 2). Together they work to prevent bait and switch tactics. The first waiting period after the final disclosures ensures that all affected consumers are informed of their loan terms before closing. The second period ensures that any last minute changes imposed by the creditor (after the final disclosures) are disclosed in advance of closing as well.

The corrected redisclosure period guarantees consumers a three-day cooling-off period (or a final shopping period), before they are obligated on the note, should the lender change any terms (or, in Alternative 2, the APR or fixed-rate feature) between application and closing. This is a critical period of time that allows the borrower to look for alternatives if the lender changes the loan terms from what the borrower bargained for. In addition, failure to require redisclosure before consummation when the early disclosures are inaccurate undermines the validity of early disclosures. Without mandatory redisclosure before closing, lenders have no incentive to deliver accurate early disclosures, making a mockery of TILA's core purposes of market efficiency and transparency. This three-day period only arises if the creditor changes the terms of the offered loan. Creditors should not be permitted to change the terms of the loan in order to take advantage of a bona fide personal emergency or even a scheduled closing.

Even in circumstances when the consumer waives the early disclosures, the Board should not permit waiver of redisclosure if the terms change. Under the MDIA, Congress required that final disclosures be given at the time of waiver.[154] For this term, "final disclosures," to have any meaning, creditors cannot change the loan terms. A change in the final disclosures must restart the clock, as it does currently for TIL rescission purposes.[155] A consumer applying for a loan in an emergency needs to know that the terms she is agreeing to are not subject to change. The Board also has used the "term" final disclosures—a term that only will retain its meaning without waiver.

The disclosures provide information to individual consumers. They also protect the integrity of the system by allowing all consumers to rely on the validity of the disclosures. Mandatory disclosures level the playing field between transparent lenders and predators, by requiring all to show the price of credit. Like vaccinations and public health, an individual decision to opt out of the system has consequences for everyone. Opt outs from the disclosures should not be countenanced lightly or for reasons of convenience alone.

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[154] Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 2502(a)(6), 122 Stat. 2654, 2857 (codified at 15 U.S.C. §1638(b)(2)(F)(iii)).

[155] Reg. Z §226.23 (a)(3) ("The consumer may exercise the right to rescind until midnight of the third business day following . . . delivery of all material disclosures . . . .").

Lenders can commit themselves to loan terms seven days before closing. They certainly can determine any needed changes three days before consummation. They will do so if the Board does not authorize waiver of the final and corrected redisclosure provisions. Creditors will have no incentive to do so, however, if the Board permits waiver of the these provisions. The lack of certainty in loan terms benefits neither consumers nor honest creditors.

Seldom, if ever, will a bona fide personal emergency unexpectedly arise in the usually short interval between the early disclosure and consummation. Moreover, given the generous tolerances, small, last minute changes in settlement amounts will not trigger the redisclosure requirement. Only major changes in the cost or terms of the loan—most of which are now prohibited by the Department of Housing and Urban Development (HUD) pursuant to its authority under the Real Estate Settlement Procedures Act (RESPA)—will trigger the redisclosure requirement. Creditors can easily prevent any delay occasioned by the necessity for redisclosure by checking the final loan disclosures when they are given three-days before the scheduled consummation and ensuring they are correct.

c. ***Creditors Can and Should Close Loans On Time***

Creditors already must prepare the final loan documents before consummation. The process of preparing the documents is largely automated and mechanized. Creditors can, as a matter of routine, set their computer programs to spit out the final documents sufficiently before consummation that any changes between the final documents and the applied-for, agreed-upon terms can be supplied to borrowers in advance of consummation. Three business days before consummation strikes a reasonable balance between preserving consumer choice and imposing limitations upon creditors. The creditor should be required to address potential changes in loan terms before closing or abide by the early disclosures.[156]

Without mandated disclosure, creditors often are unwilling to disclose, precisely because of a perceived competitive disadvantage: if the creditor's prices are high, the creditor risks being underbid; if creditor's prices are fair or even low, the creditor still risks being underbid by a predator that has no intention of following through. As we highlighted in our MDIA comments, one advocate reported to us that a large national lender refused to supply her grandfather with any loan documents prior to closing. When she called directly to ask for the documents, so that she could review them before consummation, the banker confirmed that it was bank policy never to provide the loan documents, except when provision of the documents was mandated by law. The banker said the policy was in place to prevent consumers from shopping around. Allowing

[156] Contract law in some circumstances may require the lender to close on the agreed upon date. If a lender fails to close as scheduled, borrowers may be able to bring a contract claim against the lender for any damages the borrower suffers. Lenders can protect themselves from this risk in one of two ways: reviewing the final documents sufficiently in advance of closing to redisclose, if necessary, or retaining, within the APR tolerances, the original offer made to the consumer.

creditors to wait until consummation to disclose changes fosters an anticompetitive climate.

A dangerous dynamic may result when a devious creditor knows that the borrower has a date by which the loan closing must occur. If waiver of final or corrected disclosures is permitted, lenders are encouraged to wait until consummation to reveal the changed terms. As the Board has recognized, most consumers cannot back out of a loan at consummation, even if they are able to see and appreciate the change of terms amid all the other paperwork at closing.

Lenders should not be encouraged to create emergencies; lenders should be encouraged to close loans on time, with full disclosure. The Board runs the risk of sanctioning lender-created emergencies if it permits waiver of the final or corrected disclosure rights, since either may contain a change in terms. Waiver of the final or corrected disclosure period encourages lenders to create emergencies for consumers by waiting until consummation to reveal the final terms, thus forcing consumers to confront the Hobson's choice of a delayed closing or the waiver of their rights to early disclosure. If creditors know that they must supply consumers with the final documents three-days before consummation or honor their original disclosures, they will supply consumers with truly final documents three-days before consummation. If lenders can get consumers to waive the final or redislosure waiting period, they no longer will face the discipline this choice imposes to get the disclosures done correctly, before closing. The Board must not allow the creditor's delay to become the homeowner's emergency. The Board should not ratify creditors' sloppy business practices.

The Board should not succumb to the false dichotomy: closing on time or pre-closing disclosure. Creditors can and should manage loan closings to provide for complete and timely disclosure.

d. *Post-Application Emergencies Are Rare Events*

The Board identifies only one emergency that would require waiver of the disclosures: a foreclosure. Rare indeed is the foreclosure (or similar emergency) that catches a homeowner unaware between the application for refinancing and consummation. Even in such a case, only if the creditor significantly increases the cost or changes major terms of the loan, would corrected disclosures be required. And even if corrected disclosures are required, the creditor should be able to accommodate the borrower by expediting its review and completion of the closing documents.

2. The Board Should Narrow Its Waiver Rules for All of the Seven- and Three-Day Periods

As noted above, we urge the Board not to allow waiver of the requirement that the final disclosures, and any corrected disclosures, be delivered to the consumer three days before closing. However, if the Board retains this waiver provision, or even if it retains it

just for the seven-day disclosure rule, it should be narrowed significantly in several respects.

First, the Board should amend the seven-day disclosure rule or add a Commentary provision that none of the time periods can be waived if the creditor's inaction or delay played any role in creating the emergency.

Second, both the rule and the Commentary should be amended to state that the personal financial emergency must occur within the seven- or three-day period. There is no reason to permit waiver if the emergency will occur outside of the waiting period. If the emergency occurs outside of the waiting period, it is not TILA that is delaying consummation, but the lender. TILA should not provide coverage for a creditor's delay.

Third, the Board should restrict waiver of the three-day rules to circumstances in which there are only minor changes from the good faith estimate. For example, waiver should not be allowed if the creditor is adding a variable rate feature, a prepayment penalty, a negative amortization or interest-only feature, or a balloon payment, or is lengthening the term of the loan or requiring additional security. Nor should waiver be allowed if a change in the APR exceeds a certain amount, or additional broker fees are added.

We also support continuation of the existing rule's limit on the situations in which the three-day period between disclosure and closing can be waived to those in which a "bona fide personal emergency" exists. We fully support the Board's strict insistence on the existence of a true emergency. This limitation makes sense and simplifies compliance. A standard rule is easier to comply with and easier to monitor for compliance. Moreover, the requirement of a true bona fide emergency, tightly drawn, is essential to preserving the integrity of the disclosures. Without requiring a real exigency to be present, the newly required early disclosures would fast become an anachronism. Creditors could elicit waivers whenever it suited them.

The additional restrictions we are proposing in this section should apply to all waivers—the seven-day period, the three-day final disclosure requirement, and the three-day redisclosure requirement. In addition, as discussed in the next subsection, further restrictions should be imposed on waiver of the redisclosure requirement.

3. Further Narrowing of the Waiver Provision for Corrected Redisclosure Is Particularly Important

As discussed above, it is particularly inappropriate to allow waiver of the requirement that the creditor provide corrected redisclosures three days before closing. If the Board nonetheless allows this right to be waived, there should be even tighter limits on their waiver than on waiver of the early disclosures.

It is the guarantee that the "final" disclosures are binding that makes them useful for shopping purposes and restricts creditors from baiting and switching. If the Board authorizes waiver of redisclosure, it should implement new strict limits on that waiver.

Whether the emergency triggering waiver is a foreclosure, the threatened repossession of other property, or even the promise to purchase the home on a certain day, the existence of the "emergency" should not be the excuse for the creditor's change in the terms at the last minute. The Board must prevent creditors from taking advantage of a borrowers' known emergency to change the loan terms to consumers' disadvantage.

- Only emergencies that *develop between the time of application and consummation* should trigger the possibility of a waiver of the redisclosure right. These will be rare and should be well documented.
- If the borrower *at application* seeks an expedited closing or a closing by a date certain, the lender should be permitted to increase the APR or otherwise change key terms *only* if the lender is able to include these in the final disclosures three days before the scheduled consummation.
- Only significant emergencies, such as foreclosures, that must be addressed before the expiration of the three-day redisclosure period, should count as bona fide. Emergencies not necessitating action within the three-day period should not count. This clarification should be added to the regulation as well as the Commentary.
- Lenders should provide a statement to the consumer documenting any key changes from the early disclosure and explaining why they were made: Did the interest rate increase? Were fees added? Why were these changes not known to the lender at the time the early disclosures were provided?
- The Board should require creditors to report to the Board the incidence of corrected disclosure and waiver of the final and corrected disclosures.

Without these limitations, there will be nothing to prevent waiver of the final and corrected disclosure rights from becoming routine. If waiver of the redisclosure rights becomes routine, the early disclosures will remain as meaningless as they have been historically, used more often for bait and switch than for shopping.

F. *The Board Should Adopt Strong Rules to Protect the Accuracy of Disclosures*

The Board asks how to prevent overstated early disclosures from undermining the integrity of the early disclosure process. Presently, there is a substantial problem of overstated disclosures because they generally are not actionable, unlike understated disclosures, and they allow creditors to build in an extra tolerance cushion. Because shopping behavior is limited, such overstating does not appear to adversely affect a creditor's business returns.

The Board should take two steps to address this problem. First, it should adopt a prohibition against overstated early disclosures. Second, it should use its exemption

authority to make overdisclosure actionable. Consumers currently do not shop enough to police the market and this is unlikely to change. By contrast, if overstatements are actionable, creditors will have an incentive to comply.

The Board also asks whether numerical tolerances are needed other than for the APR and for interest and settlement charges. We urge the Board not to adopt any other numerical tolerances. Small changes in payment disclosure violations can make a large cumulative difference in what a borrower pays and also may have a psychological impact on a borrower's choice. Thus, the Board should not adopt a tolerance for payment disclosures.

Proposed Regulation Z § 226.19(a)(2)(iv) would provide that a disclosed APR is considered accurate if the APR decreases later due to a discount 1) the creditor gives the consumer to induce periodic payments by automated debit from a consumer' deposit account or 2) the title insurer gives the consumer a discount on voluntary owner's title insurance. Under the proposal, these changes would not trigger a new three business day waiting period, although they would be required to be disclosed before consummation, consistent with Regulation Z § 226.17(f).

The Board solicits comments on whether a disclosed APR that is higher than the actual APR at consummation should be considered accurate in other circumstances. We urge the Board not to adopt any additional exceptions. In addition, we urge the Board to delete the first exception. Discounts such as that described in the first scenario often result in deceptive disclosures. For example, some loan products in the past have included a rate discount for consumers paying on time. The disclosures included this assumption in the calculation because such payments were compliant with the contract, yet many homeowners actually were required to pay more when they missed payment deadlines. If a problem arises with debit payments a consumer will no longer qualify for the loan discount, yet the disclosures will not have provided the real cost of the loan.

The Board would not even need to consider the question of whether to adopt the first scenario on accuracy if it adopts NCLC's recommendation regarding proposed Official Staff Commentary § 226.17(c)(1), in which we strongly recommend disregarding incentives when making disclosures unless the incentive can not be cancelled. Where they can be cancelled, there is too much of a danger that the disclosures will not be accurate for some portion of the recipients. Allowing such a rule invites creditors to game the system by constructing incentive programs that give the appearance of lower loan costs.

There are instances where the finance charge may go down at consummation but the APR may go up. The Board proposes to say that in these instances the APR would be inaccurate and therefore would trigger redisclosure because an APR only *results from* an overstated finance charge and thus does not constitute an inaccurate APR where the APR also is overstated. We concur with this analysis and support this clarification.

G. *The Board Should Offer Additional Guidance on Reasonable Assumptions for Treatment of Voluntary Charges in Early Disclosures*

The Board has requested comment on whether it should offer additional guidance in the area of "reasonable assumptions that may be made regarding voluntary or optional charges in early TILA disclosures." 74 Fed. Reg. 43,247. Such guidance would be helpful. The proposed Official Staff Commentary directs the creditor to make these disclosures "on the best information reasonably available" and permits the creditor to "provide explanatory material concerning the estimates and the contingencies that may affect the actual terms . . . ." Proposed Official Staff Commentary § 226.19(19)(1), 74 Fed. Reg. 43,292. This commentary would be strengthened by an illustrative list of information sources that would be expected to contain the best information reasonably available for these purposes. Potential sources might include the creditor's own records (for information about what a particular charge turned out to be for other borrowers with a similar profile to the borrower to whom the early disclosure is being made) as well as pricing information from third party vendors that the creditor frequently works with of the product the borrower has the option of purchasing.

H. *The Board Is Correct Not to Provide a Sweeping Exemption for Timeshare Transactions*

Finally, with regard to timeshares, we concur with the Board's conclusion that Congress did not intend to exempt timeshare transactions from any requirement to disclose to a consumer that the consumer is not obligated to consummate a loan. The exemption only applies to the new, additional early disclosure requirements.

VII. EARLY DISCLOSURES FOR ADJUSTABLE RATE MORTGAGES—§ 226.19(b)[157]

A. *Disclosure Approach Is Not Adequate*

The Board's proposal includes significant changes to the early disclosures for adjustable rate mortgages (ARMs). We want to start by commending the Board for its focus on ARMs. During the years leading up to the subprime mortgage collapse, ARMs were widely used as a way of making unaffordable loans appear affordable. In early 2006, ARMs accounted for 80% of all subprime mortgage originations.[158] The weak disclosure regime for ARMs enabled loan originators to downplay the risks of these loans, and also made it easy to bait consumers with fixed rate loans, and then switch them to ARMs.

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[157] Early and Account Opening Disclosures for HELOCs are discussed in Section III of those comments, reprinted at Appendix I, *infra*.

[158] Deborah N.Goldstein & Jamie Z. Goodson, Comments of the Ctr. for Responsible Lending on Proposed Interagency Guidance 2 (Mar. 29, 2006), available at www.ots.treas.gov/docs/9/962469.pdf.

Better ARM disclosures are clearly a critical reform. However, a disclosure approach, without substantive regulation, will not prevent another subprime mortgage crisis. The Board should not merely require disclosure of risky features of ARMs, but should impose substantive limits on those features. The sheer complexity of some ARM products dooms a disclosure approach. The policy reasons for imposing substantive limits are discussed in Section II of these comments.

This section of these comments addresses the early ARM disclosures that would be required by Proposed Regulation Z § 226.19(b). It first analyzes the scope of coverage of these requirements, then the Board's proposal to substitute two flyers for the CHARM brochure, and concludes with discussions of the format and substance of the proposed ARM program disclosures. Section XII of these comments addresses the ARM disclosures provided shortly before and at closing, and Section II, *supra*, addresses substantive regulation of ARMs.

B. *Scope Issues*

1. ARM Program Disclosures Should Be Extended to All ARMs Secured by Real Estate, and to All ARMs Regardless of Loan Term

At present, ARM program disclosures are required only for ARMs that are secured by the consumer's principal dwelling. Current Regulation Z § 226.19(b). The Board proposes to extend these requirements to all ARMs that are secured either by real property or by a dwelling. Proposed Regulation Z § 226.19(b) (prefatory language). This is an appropriate step. First, even if the real estate that secures the loan is not the consumer's principal dwelling, but is a vacant lot or a second home, the consumer will be placing a great deal at risk in the transaction and should be informed of that risk. Second, even though such a transaction does not involve a risk of loss of a home, overly risky loans are not only bad for the individual borrower, but are also bad for the economy as a whole. To the extent that early disclosure about a loan's dangerous features enables a borrower to exercise more careful judgment, the economy as a whole benefits.

We also support the Board's decision not to exempt ARMs with terms of less than a year from the early disclosure requirements. If the ARM disclosure requirements have the effect of reducing irresponsible loans, but offering a series of short-term ARMs provides a way to continue business as usual, irresponsible lenders will likely migrate to short-term ARMs.

2. Renewable Short-Term Balloon Notes Should Be Treated As ARMs

In a change from the existing rules (see existing Official Staff Commentary § 226.17(c)(1)-11), the Board proposes not to define short-term renewable balloon notes as ARMs. Proposed Official Staff Commentary § 226.17(c)(1)-11. However, a short-term renewable balloon note is the functional equivalent of an ARM. Indeed, it is the functional equivalent of a very disadvantageous ARM, because by structuring the transaction in this way the creditor can secure complete discretion over rate increases.

The Board's Section-by Section Analysis provides only the briefest discussion of this change, and no rationale for it. 74 Fed. Reg. 43,264.

It is true that some of the other loan types that the Board proposes to remove from the definition of ARMs—shared equity loans and preferred rate loans, for example—do not have the adjustable rate features that the Board is requiring the creditor to disclose. For these loans, we do not disagree with their removal from the definition of an ARM. However, renewable short-term balloon notes are like ARMS in that they have an introductory period and a schedule for rate and payment amount changes. (The schedule is whatever the renewal period is.) If a renewable short-term balloon note has a formula for rate changes or a cap, this should be disclosed, and the absence of a formula or cap should also be disclosed.

The irrationality of the exclusion of short-term renewable balloon notes from the definition of ARMs is highlighted by the fact that the Board is apparently continuing to treat them as adjustable rate transactions when they are not secured by real property or a dwelling. *See* Proposed Official Staff Commentary § 226.17(c)(1)-11. The Board does not give any reason for treating the same transaction differently in these two contexts.

To our knowledge, short-term renewal balloon notes are not a common means of consumer mortgage financing. However, if the recent subprime mortgage meltdown teaches anything, it is that loan originators will find and exploit weaknesses in the regulatory system just as surely as water finds a crack. If short-term renewable balloon notes provide a way to evade ARM disclosure requirements (not to mention any substantive limits that the Board imposes on ARMs), loan originators will have an incentive to structure loans in exactly that way.

3. Board's Proposal Is Unclear in Its Treatment of Preferred Rate Loans and Price Level Adjusted Mortgages

The Board states in its Section-by-Section Analysis that it is revising the Commentary to provide that preferred rate loans and price level adjusted mortgages are not adjustable rate mortgages. 74 Fed. Reg. 43,254. However, the Commentary appears to do the opposite. Proposed Official Staff Commentary § 226.17(c)(1)(iii)-4 states:

> In general, variable-rate transactions include: …
>
> ii. Preferred rate loans…
>
> iii. "Price level adjusted mortgages… ."

However, in Proposed Official Staff Commentary § 226.19(b)-5, the Board provides that these same two types of transactions, when secured by real property or a dwelling, are *not* ARMs for purposes of Regulation Z § 226.19(b).

We agree that these two types of mortgages should not be treated as ARMs for purposes of the early ARM disclosures required by Regulation Z § 226.19(b). The early ARM disclosures simply do not match the features of these loans. However, we question

why the Board has chosen to draft the rule in such a confusing way. Instead of defining these two types of mortgages as ARMs, and then defining them as non-ARMs, the Board should write a separate rule that describes how they are to be treated. That rule should list any ARM requirements to which these types of mortgages are subject. We also do not understand why the definition should be different for mortgage credit as compared to non-mortgage credit.

4. The Board Should Consider Requiring Early Disclosures for Other Complex, Risky Products

The Board has solicited comment on whether it should require loan program disclosures for any non-ARM loan products. 74 Fed. Reg. 43,232, 43,262 (Aug. 26, 2009). We urge the Board to require loan program disclosures at the same early stage for all loan products that are complex, unusual, or risky. Examples are interest-only loans, any loan with a negative equity feature, and shared-appreciation or shared-equity loans. In other parts of the these comments, we urge the Board to ban certain especially risky loan products. To the extent that the Board does not ban them, it should require special disclosures at an early stage.

While in recent years most interest-only and negative-equity loans have been ARMs, there is no reason that these products must have adjustable rates. Thus, under the Board's proposal, fixed-rate interest-only or negative-equity loans would be exempt from the loan program disclosure requirement. Since these are complex products with features that most consumers do not expect, loan program disclosures should be provided.

C. Replacement of the CHARM Booklet with Two One-Page Flyers Is an Improvement

In the past, the Board has required ARM lenders to provide two documents to borrowers before they apply for an ARM: a loan program disclosure and the Consumer Handbook on Adjustable Rate Mortgages (CHARM booklet).

The Board is proposing to eliminate the CHARM booklet. We support this proposal.[159] In our view, the CHARM booklet has been of little use to consumers. Based on reports from attorneys handling mortgage cases and our own interviews of clients, the CHARM booklet has made little or no impression on consumers. In fact, it has made so little impression on consumers that we question whether many creditors actually even provided it. If they provided it, consumers did not make use of it. The Board's consumer testing leads to these same conclusions. 74 Fed. Reg. 43,268.[160]

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[159] Although this discussion focuses on ARMs, we support the Board's proposal to distribute the two new one-page flyers upon application for any closed-end loan secured by real property or a dwelling. 74 Fed. Reg. 43,238. And to the extent we suggest improvements for the "Key Questions to Ask About Your Mortgage" flyer, they should be understood as applying to the flyer as distributed in connection with all closed-end loans secured by real property or a dwelling, not just ARMs.

[160] *See also* ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 19 (July 16, 2009).

The complexity of the subject makes the CHARM booklet difficult to understand. Because the booklet is generic, it is forced to describe the full range of possible loan terms, some of which are extremely complicated and most of which will not be relevant to the consumer's loan. It provides numerical examples, but these are not keyed to the loan size the consumer is seeking. Evaluating whether an ARM is a good idea is inherently riddled with "ifs" and contingencies; trying to present these factors in a generic context makes the number of contingencies overwhelming. Consumers who were required to read the booklet as part of the Board's consumer testing found some of the material useful, but many indicated that it was so long that they would be unlikely to read it if they were shopping for a mortgage.[161]

Because of their brevity and plain language, the two one-page documents that the Board is proposing as replacements for the CHARM booklet are likely to have more impact on consumers. The flyer titled "Fixed vs. Adjustable Rate Mortgages" is clear and concise, and we have no suggestions for improving it. We have several suggestions for the "Key Questions to Ask About Your Mortgage" flyer:

- Consider using the term "negative amortization," as discussed below in connection with the ARM program disclosures.
- In the interest-only and negative amortization boxes, add the fact that these loans usually require a substantial increase in the monthly payment amount after a period of lower payments.
- Rephrase the question in the last box, "Will I have to document my employment, income, and assets to get this loan?," so that it does not suggest that it is an unwonted burden to provide such documentation. The current phrasing could encourage consumers to negotiate *for* a no-doc or low-doc loan. A better phrasing would be "Will the lender base this loan on my income and assets [or, in the alternative, "on my documented income and assets"]?"

We recommend that the CHARM booklet be retained on the Board's website. On the website, we recommend that it be available in a variety of formats rather than just than PDF. PDF documents take a long time to download, which can be especially problematic for a low-income consumer who is using a dial-up modem, older equipment, or a library computer. It is also harder to navigate within a PDF document than when the content is displayed in other ways.

The Board's consumer testing regarding the CHARM booklet yields another lesson for this rulemaking. As noted above, the Board's consumer testing suggests that creditors have been failing to give consumers the CHARM booklet. The broader lesson is that the Board should not count on disclosures being made unless there is a clear, easy private cause of action to enforce the disclosure requirement. The lack of compliance with the requirement to provide the CHARM booklet is mirrored by creditors' widespread violation of the Truth in Lending advertising rules, which are also not enforceable by consumers. Whatever requirements the Board imposes in this

[161] ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 19, 22 (July 16, 2009).

rulemaking, be they disclosure requirements or substantive requirements, the Board should not expect creditor compliance if there is no private cause of action for statutory damages to enforce the requirement. Requirements that are critical to the Board's goals should be written so that they are part of the requirements for which statutory damages are available.

D. *Format of the Proposed ARM Program Disclosure*

1. The Board's Prescription of a Standard Format Is a Significant Improvement but Includes Loopholes That Should Be Closed

We commend the Board for its proposal to require a standardized format for the ARM loan program disclosure. Proposed Regulation Z § 226.19(b)(4). The Board's consumer testing confirms that consumers find it much easier to absorb information if it is presented in a standardized, familiar format. Requiring a standardized format also eases creditor compliance and eliminates the temptation to manipulate the formatting as a way of de-emphasizing negative information.

In particular, we commend the Board for requiring most of the disclosures to appear in tabular form, an approach that has been successful in the open-end credit context. As the Board's consumer testing showed, consumers find narrative disclosures more difficult to absorb. 75 Fed. Reg. 43,235. The Board's proposal to require that the "Key Questions" disclosures appear in a specified order is also particularly important, because it will make it easier for consumers to compare ARMs side-by-side. We also support the Board's proposal to subject the ARM program disclosures to the requirement set forth at Proposed Regulation Z § 226.37(a)(2) that the disclosures be grouped together, segregated from everything else, and free from most other information. *See* Proposed Regulation Z § 226.19(b)(4)(i).

However, the Board's proposal leaves several loopholes open. First, we recommend that the Board adopt a rule, applicable to all disclosures, stating that any other documents provided in connection with the transaction must not contradict the TIL disclosures nor render the TIL disclosures unclear or less conspicuous. Second, the Board should adopt a requirement to ensure that the TIL disclosures are presented prominently, rather than being buried in a pile of other documents. For example, the Board could require that TIL disclosures be mailed separately from other documents, or provided as the first or top item at any in-person meeting.

A third issue relates to length. The Board's model form is a single page. If the Board envisions that the ARM program disclosures will be a stand-alone one-page document, it should make this an explicit requirement. Otherwise, creditors could construe the rule as allowing them to bury the loan program disclosure deep within a multi-page document or on legal-sized paper with other things on the same page.

Fourth, the Board's proposal states that the "content" of the ARM program disclosure should be "substantially similar to Form H-4(B)." Proposed Regulation Z §

226.19(b)(4)(iv). It is not completely clear whether this means that the *language* used, as opposed to the subject matter covered, must be substantially similar to the model form. Indeed, for high-risk, counter-intuitive loan features such as negative amortization, the Board should mandate that creditors use phrasing that is identical to that on the model form that the Board has consumer-tested. These disclosures are so difficult for consumers to understand and absorb that even small phrasing changes could dramatically reduce their understandability and enable creditors to downplay disadvantageous loan features. If the Board crafts the language through consumer testing, it should not allow creditors to vary that language.

In fact, it is quite unclear what level of adherence to the phrasing in the model forms the Board is proposing to require. Proposed Regulation Z § 226.19(b)(4)(iv) merely states that the "content" of the ARM program disclosure should be "substantially similar to Form H-4(B)." By contrast, the Board is proposing to require that creditors hand out the two one-page Board publications on ARMs "as published by the Board." Proposed Regulation Z § 226.19(c). The difference in language implies that creditors can phrase the ARM program disclosures however they choose, as long as the *content* is substantially the same as that in the model form. In addition, the Commentary is phrased so that it merely suggests particular language for the ARM program disclosure.[162] However, the Board's section-by-section analysis seems to assume that creditors would use the specific language in the model form.[163] If the Board wants creditors to use the plain language disclosures that it has crafted through consumer testing—and it should want this result, for all the reasons cited in its proposal and these comments—it must make this requirement much clearer.

2. The Board's Lax Rule Regarding Electronic Disclosures Will Enable Creditors to Make the ARM Program Disclosure Requirements Meaningless

The Board's proposed rules regarding electronic provision of ARM program disclosures open an enormous loophole that will enable creditors to make those disclosure requirements meaningless for many consumers. Under Proposed Regulation Z §§ 226.17(a)(1) and 226.19(d)(2), creditors would be allowed to make the ARM program disclosures electronically, *without complying with the federal E-SIGN statute*, to a consumer *who was physically present in the creditor's office*. The creditor would be able to make the ARM program disclosures electronically simply by directing the consumer to a computer terminal in the loan office to fill out the loan application. This part of the proposed rule is carried over in large part from a rule that the Board adopted in 2007.[164]

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[162] *See, e.g.*, Official Staff Commentary § 226.19(b)(1)(iv)-1 ("For example, the creditor might state…").
[163] 74 Fed. Reg. 43,265 ("Consumer testing and document design principles suggest that keeping language and design elements consistent between forms improves consumers' ability to identify and track any changes in the information being disclosed. … The Board believes that consistently using the "Key Questions" terminology would enhance consumers' ability to identify, review and understand the disclosed terms across all disclosures… ."), *id.* at 43,267 ("participants generally understood the revised transaction-specific plain-language explanation of negative amortization's causes and effects when disclosed in the "Key Questions" format… . Consumer testing showed that participants understood the revised language regarding a demand feature ….").
[164] 72 Fed. Reg. 63,462 (Nov. 9, 2007).

There is no apparent reason for the Board's decision to abrogate the important consumer protections of E-SIGN in this situation. E-SIGN requires, critically, that the consumer go through a specific consent procedure to receive disclosures electronically. 15 U.S.C. § 7001(c). This is a particularly important protection when a consumer does not seek out an electronic transaction, but goes to the creditor's offices and is directed by the creditor to use computer equipment in the creditor's office space. The consumer may not have a personal computer at home, or any way to save, use, or retrieve the electronic information outside of the creditor's offices. In addition, E-Sign has special protections against alteration of electronic documents that will not apply if the Board adopts this broad exemption. 15 U.S.C. § 7001(d), (e).

The E-Sign requirements are particularly important in light of the Board's proposed improvements to the ARM program disclosure. The ARM program disclosure will no longer be a document of impenetrable prose, but will contain highly important specific information about the loan program the consumer is applying for. It will be a key part of the Board's efforts to deter bait-and-switch tactics. If, however, the ARM program disclosure requirements merely make a fleeting appearance on an electronic screen in the creditor's office, they will be of little use to the consumer. The consumer will not be able to refer to them again to see if the credit terms offered have changed. If the ARM program disclosures are to have any use in consumer shopping, they must be provided in a form that will be practical for the consumer to retain. When the consumer is physically present in the creditor's office, there is no excuse not to offer the consumer a paper copy.

Even when a consumer accesses a loan application electronically from home, using the consumer's own equipment, the E-SIGN protections are important. E-Sign provides important protections—protections that are absent from Regulation Z—against alteration of electronic documents. 15 U.S.C. § 7001(d), (e). The ARM program disclosures can help deter bait and switch tactics, but only if the Board provides stronger protections to make sure consumers are actually able to retain them and refer back to them.

We also question whether the exemption of the early ARM disclosures is within the Board's statutory authority. E-Sign gives federal regulatory agencies such as the Board the authority to exempt a specified category or type of record from E-Sign's consumer consent requirements if the exemption is necessary to eliminate a substantial burden on electronic commerce and will not increase the material risk of harm to consumers.[165] However, this allows exemptions only from E-Sign's consumer consent requirements, not its other important protections regarding the accuracy and accessibility of electronic documents.[166] Thus, the exemption appears to go beyond the exemption authority granted by E-Sign.

[165] 15 U.S.C. § 7004(d).
[166] 15 U.S.C. § 7001(d), (e).

Nor can the exemption of these disclosures from all E-Sign requirements be justified by TILA. TILA § 1605(a) allows the Board to create exceptions for certain classes of transactions, but that authority, being part of TILA, can only authorize exemptions from TILA's requirements.

When the Board originally adopted this exemption in 2007, it also suggested that the exempted disclosures might not "relat[e] to a transaction,"[167] as required for E-Sign's applicability.[168] This theory is also unsound. The early ARM disclosures are required under current Regulation Z § 226.19(b) when a consumer submits an application for an ARM). An application for an ARM clearly relates to a transaction.

Both for policy reasons and because the Board has exceeded its exemption authority, we urge the Board to withdraw the portion of the proposed rule that would exempt the early ARM disclosures from E-Sign's requirements when the consumer accesses an ARM application electronically.

E. *Content of the Proposed ARM Program Disclosure*

1. The Heading for the ARM Program Disclosure Should Use the Term "Adjustable Rate Mortgage," Identify the Loan Type, and Give the Name of the Loan Product

Under the Board's proposal, the ARM program disclosures need only have the heading "Adjustable Rate Mortgage" or "ARM." Proposed Regulation Z § 226.19(b) (prefatory language), (b)(4)(iii). The proposed regulation allows but does not require the creditor to put the name of the creditor and the name of the loan program in the heading. Proposed Regulation Z § 226.19(b)(4)(iii). We have a number of concerns about this proposal.

First, the Board should require the heading to use the term "Adjustable Rate Mortgage," not "ARM." Not all consumers understand the acronym "ARM."

Second, the Board should require the creditor to state the loan type either in the heading or immediately under the heading. For the disclosures given at closing, the Board is proposing to require a more specific disclosure of the "loan type," including an indication of whether the loan has a step-payment, payment option, interest-only, or negative amortization feature. Proposed Regulation Z § 226.38(a)(3). But it has not proposed to require this disclosure to be part of the ARM program disclosure.

As discussed in Section XII(F) of these comments, we have serious concerns about the Board's proposed categorization of loans for purposes of the loan type disclosure. However, we support the concept. If the specific problems we point out are resolved, this new disclosure could benefit consumers and should be included in the ARM program disclosures.

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[167] 72 Fed. Reg. 63,462, 63,463 (Nov. 9, 2007).
[168] 15 U.S.C. § 7001(c), (d)(1), (3).

Including the loan type in the ARM program is important for two reasons. First, requiring this same level of specificity will create consistency between the early disclosures and the disclosures given closer to and at closing. A consumer will be better able to determine if the loan product provided at closing is in fact the same one that was originally offered. Reports from attorneys handling cases and our own interviews of clients have shown that loan originators have often added risky features to loans well into the origination process, after the borrower was already committed to the loan. Indeed, the Board's own consumer testing showed exactly this practice. 74 Fed. Reg. 43,259. Second, identifying these risky features in or immediately under the heading is more likely to draw them to the consumer's attention, and make the consumer more attuned to the question of whether these risks should be taken.

Permitting the creditor to use the name of the loan program in the heading, as Proposed Regulation Z § 226.19(b)(4)(iii) would do, is insufficient. First, the requirement should be mandatory. Second, the name the creditor gives its ARM program may be completely opaque: "Bank East Preferred Customer Loan" or "Bank East Equity Builder Loan." Creditors could easily give their ARM program disclosure a heading that downplays the loan's risky features, or even obscures the fact that it is an ARM.

Finally, the Board should require the heading to include a unique, clearly recognizable name for the specific loan product to which the disclosure relates. A creditor may have more than one loan program that would fall within a loan type. For example, looking at Model Form H-4(D), a bank might offer several ARM programs that meet the description "3/1 Adjustable Rate Mortgage"—one with a 7% instead of 6% lifetime cap on rate increases, one with adjustments every 6 months instead of every 12 months, and one with a longer prepayment penalty period. If all of these were identified simply as "3/1 Adjustable Rate Mortgage," it would be easy to bait consumers with one loan and then switch them to another.

The rule should provide that, where the creditor offers more than one loan product that meets the description in the heading, each one must be given a unique, clearly recognizable name, and that name must be included as a subheading on the ARM program disclosure. The Board should also require that this unique name appear on other disclosures provided to the consumer later in the process. The Board should require that the unique part of the loan product name be a word, not a number. For example, the unique name should not be "Bank East Equity Builder Loan Program 89508-2." The Board should also require that the unique name not include abbreviations or jargon such as "2/28" or "3/1."

2. The Proposed Disclosure Regarding Discounted Initial Rates Is Far Too Weak

The Board proposes to require that creditors disclose the effect of having an initial interest rate that is not based on the index or formula that applies to interest rate adjustments. Proposed Regulation Z § 226.19(b)(1)(i).

The Board should be commended for recognizing that early, prominent disclosure of a teaser rate is critical. During the subprime mortgage boom, it was common for lenders to trumpet their teaser rates in advertisements, never mentioning that the teaser rate lasted just a short period.[169]

However, the Board's proposed disclosure language is far too technical and obscure. Model Form H-4(F) uses this language: "The interest rate is discounted and will stay the same for a 1-month introductory period. After this initial period, the interest rate could increase."

This language is woefully inadequate. First, the statement "the interest rate *is discounted*" conveys the wrong message. It conveys to the consumer that the lender is providing a discounted interest rate for this loan—just what the consumer wants to hear. Significantly, the statement is not confined to the *initial* interest rate, but appears to be a general statement. Second, the statement "[a]fter this initial period, the interest rate *could* increase" grossly understates the situation. For many of the subprime mortgages generated during the boom years, an interest rate increase was a mathematical certainty after the teaser rate expired. For example, if the teaser rate is 2% and the margin is 5 points above the LIBOR rate, after the teaser rate expires the interest rate will go up to a minimum of 5% *even if the LIBOR rate is zero*. Even if an increase in the interest rate is not a mathematical certainty, for most teaser-rate loans the interest rate will increase at the end of the teaser period except in the extremely unlikely event of a huge, unprecedented plunge in the index rates. *The Board's disclosure fails to convey this essential fact*.

Without major revision, the disclosure not only fails to convey the risks created by a teaser rate, but is likely to be misleading. A better disclosure would be something along these lines:

The initial ___% interest rate for this loan is a teaser rate that will only be in effect for one month. After that, the interest rate—and your monthly payment—are likely to increase [substantially]. Your interest rate will go up to ____% even if market interest rates stay the same.

As part of this disclosure requirement, we would ask that the Board define when a rate increase should be termed "substantial." The Board might also consider allowing creditors to replace the clear but somewhat pejorative term "teaser rate" with a more neutral term such as "initial rate" or "introductory rate" where the difference between the initial rate and the fully-indexed rate was slight.

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[169] For example, Chevy Chase Bank had a mortgage loan product that it identified as its "WS Cashflow 5-Year Fixed Note Interest Rate: 1.950%". In fact, the loan had a teaser rate that applied only to the first month. After that, the interest rate could (and did) increase even though the payment did not, and the loan quickly moved into negative amortization. *See* Andrews v. Chevy Chase Bank, 545 F.3d 570, 572 (7th Cir. 2008).

In the Board's consumer testing, a few consumers found the term "teaser rate" to be "insulting."[170] This rather enigmatic statement should not be a reason to avoid using a clearer term. The Board's consumer testing showed that consumers have a great deal of difficulty understanding teaser rates.[171] Even after many rounds of testing, and many attempts to improve the disclosure, consumers still had great difficulty understanding the effect of a teaser rate. In the final round of testing, while most consumers believed, based on their general distrust of ARMs, that the interest rate was likely to increase after the initial period, only a few even noticed the disclosure that indicated that the initial rate was discounted and would increase after the introductory period.[172] For these reasons, the Board should conduct further testing to determine whether "teaser rate" conveys the information better to consumers.

Consumers' difficulty in finding and understanding teaser rate disclosures also highlights another key concern. The complexity of mortgage products, and their many risky features, are simply too much for consumers to absorb, much less weigh. Even if the Board's main goal is to regulate the market through disclosure—a goal that we think is unrealistic—it should prohibit certain risky and complex mortgage terms simply as a way of making disclosures more effective. Consumers are more likely to be able to absorb disclosures if there are fewer different loan features to deal with. Where consumer testing shows that disclosures are ineffective in conveying a risky loan term to consumers, that loan term should be prohibited.

Moreover, even if these terms could be disclosed clearly, they are fundamentally unfair to consumers and create massive potential instability for the economy at large. Using disclosure as a band-aid to mitigate risk is an insufficient approach.

3. The Board Should Reconsider Its Elimination of Two Items from the List of Information That Must Be Included in the ARM Program Disclosure

The information that the Board is proposing to require creditors to include in the ARM program disclosure tracks the current requirements fairly closely. The Board is proposing to delete the requirement of disclosure of four items:

- *The suggestion that the consumer ask about the current margin value and interest rate*. Current Regulation Z § 226.19(b)(2)(iv). We question whether it is wise to eliminate this disclosure requirement, and to fail to replace it with anything specific about the actual interest rate and margin that the creditor is offering. Under the Board's proposal, only the maximum rate or annual/lifetime cap will appear. Yet the interest rate—the piece of information most important to

[170] ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 61 (July 16, 2009).
[171] ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 28, 36–37, 53 (July 16, 2009).
[172] ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 69 (July 16, 2009).

consumers[173]—will not be disclosed or even mentioned. The proposed disclosure does not even identify the margin, which would enable at least some consumers to determine the interest rate. Further, without a statement of the actual interest rate, consumers are likely to be misled by the information about the maximum rate or cap, believing it to be their interest rate. We recommend that the existing language be restored.

- *The $10,000 historical example and an explanation of how to base calculations on it*. Current Regulation Z § 226.19(b)(2)(viii), (ix). We wholeheartedly support elimination of this disclosure requirement. It is confusing and of very little use.

- *The type of information that will be provided in notices of adjustments and the timing of such notices*. Current Regulation Z § 226.19(b)(2)(xi). This information is irrelevant to a consumer's choice of a loan product and merely distracts from the other disclosures. We support the Board's proposal to eliminate it.

- *A statement that other disclosure forms are available for the creditor's other ARM programs*. Current Regulation Z § 226.19(b)(2)(xii). We question whether it is wise to eliminate this disclosure requirement. Disclosing that the creditor offers other ARM programs might counteract steering of borrowers into disadvantageous loan products. The disclosure should only be required, however, if the lender actually has other ARM programs. However, regardless of whether the lender has other ARM programs, the Board should require a statement encouraging consumers to continue to shop for credit, such as "**You have the right to shop for credit. Ask other lenders what loan terms they offer.**"

4. Disclosure of Caps on Rate and Payment Increases Is Appropriate, but the Board Should Prohibit Payment Caps That Are Not Tied to Rate Caps

The Board is proposing to continue the existing rule's requirement that any limits on rate and payment increases be disclosed. Proposed Regulation Z § 226.19(b)(1)(iv). These limits are of critical importance, because they define the extent of the risk that the consumer takes on with an ARM. We strongly support disclosure of this information.

However, disclosure alone is inadequate for caps on payment increases. In recent years, a growing number of loans capped the payment but not the rate: a loan product that the Seventh Circuit has aptly termed a "trap for the unwary."[174] The loan would move into negative amortization in a way that was invisible to the borrower. The capped payment would lead the borrower to believe that the loan was still affordable. The Board

[173] In the Board's consumer testing, several focus group participants stated that the actual interest rate for the loan was the piece of information that was most important to them. In the absence of this information, they stated that most of the information in the existing ARM program disclosures was not important to them. ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 17 (July 16, 2009).

[174] *See* Andrews v. Chevy Chase Bank, 545 F.3d 570, 572 (7th Cir. 2008).

has proposed monthly statements that would ameliorate this situation to some extent, but only on the back end, after the consumer had already gotten the loan.

The Board is misguided if it thinks that disclosure will convey to consumers that a cap on the payment amount is not a cap on the interest rate. This type of loan is so counter-intuitive, and so mathematically complex, that the Board should go beyond a disclosure approach and should ban it or impose significant substantive limitations on it.

5. The Board Should Delete Its Endorsement of Rate Adjustments at the Creditor's Discretion

The Board is proposing to require the ARM program disclosure to describe the index that will be used for rate adjustments. Proposed Regulation Z § 226.19(b)(1)(iii). This section of the proposed regulation appears to require somewhat more detail than the existing version, although since there are no substantive changes in the Commentary the Board may not have intended a substantive change.

There is one serious problem with the Board's proposal: its continuing endorsement of rate adjustments that are within the creditor's discretion or based on an index within the creditor's control. Proposed Official Staff Commentary § 226.19(b)(1)(iii)-2, carried over from the existing Commentary, states:

> 2. *Changes at creditor's discretion*. If interest rate changes are at the creditor's discretion, this fact must be disclosed. If an index is internally defined, such as by a creditor's prime rate, the creditor should either briefly describe that index or state that interest rate changes are at the creditor's discretion.

Inducing a consumer to enter into a contract that places the key cost factor entirely within the other party's control is the essence of unfairness. It gives the consumer an illusory contract—one in which the price may change at the other party's discretion. In the HELOC context, Congress has recognized by statute that such a contract is unfair. 15 U.S.C. § 1647. The Board should exercise its authority under 15 U.S.C. § 1639(*l*) to prohibit closed-end ARMs in which rate increases are at the creditor's discretion or measured by an index subject to the creditor's control.

6. Items to Be Disclosed in "Key Questions About Risk" Are Appropriate, but Disclosure Is an Ineffective Approach

a. *General*

The Board has proposed to require that a number of items be disclosed in a section entitled "Key Questions About Risk." In addition to information about whether the monthly payment and the interest rate can increase, the Board is requiring creditors to disclose:

- Prepayment penalties;

- Interest-only payments;
- Negative amortization;
- Balloon payment;
- Demand feature;
- No-documentation or low-documentation loans;
- Shared equity or shared-appreciation;

Most of these items are new disclosure requirements.

These items relate to highly risky loan features and their addition to the list of disclosure requirements is long overdue. However, we urge the Board not to rely on disclosure, but to impose substantive regulation on these risky features. Risky loans not only cause personal tragedy to borrowers, but also leave the country as a whole vulnerable to economic instability. Relying on disclosure to prevent another meltdown is unrealistically optimistic.

For all of the high-risk factors listed in Proposed Regulation Z § 226.19(b)(2), we recommend that the Board conduct consumer testing to determine consumers' level of comprehension of the disclosures. If the disclosure of a particular loan feature cannot be phrased so that a substantial majority of consumers readily understand and absorb its meaning, the Board should use its unfairness authority under 15 U.S.C. § 1639(*l*) to ban that loan feature, as it will be clear that disclosure will not be sufficient to protect consumers or the marketplace.

Specific comments about each proposed disclosure item follow.

b. *Prepayment Penalties*

The Board's proposal regarding early disclosure of prepayment penalties is a significant improvement over the current rules. Under the current rules, the creditor is required only to disclose that "If you pay off early, you *may* have to pay a penalty." Current Regulation Z § 226.18(k) (emphasis added). This is an extremely weak disclosure, as it states only that there may be a penalty, not that there is a penalty, and it gives no details such as the amount of the penalty or the time period during which it applies. Further, this disclosure is required only in the later disclosures, not in the ARM program disclosures, making it easier for loan originators to slip a prepayment penalty into a loan at the last minute.

We also support the Board's proposal to require the prepayment penalty disclosure to state not only the existence (or, as the existing rule requires, the possibility of the existence) of a prepayment penalty, but also the circumstances under which and the period during which it may be imposed. However, we are concerned that the Board has not clearly required creditors to use the language in the model form: "If you pay off your loan, refinance, or sell your home within [*period*], you could pay a large penalty." In particular, it is unlikely that creditors will refer to the prepayment penalty as "large"

unless the Board specifically requires them to do so. We urge the Board to mandate specific language for this disclosure.

In addition, we urge the Board to require this disclosure whenever there is a penalty for either a full or a partial prepayment. Under Proposed Regulation Z § 226.19(b)(2)(C), disclosure is required only if a penalty could be imposed "if the obligation is prepaid in full." A penalty for a partial prepayment is a highly disadvantageous feature that prevents the consumer from reducing the balance more quickly by making extra payments or larger periodic payments. As it decreases the consumer's ability to get out of a bad loan, it makes a loan more risky and should be disclosed.

c. *Interest-Only Payments*

We support the Board's decision to require a special disclosure of the fact that a loan will include interest-only payments. However, we have concerns about the phrasing of the "Key Question": "Will any of my monthly payments be interest-only?" The reference to "any of my monthly payments" tends to minimize the interest-only feature by implying that there may be just one interest-only payment. In fact, interest-only loans usually provide for several years of interest-only payments. An alternate phrasing would be "Will my payments cover just interest for a period of time?"

In addition, a highly important feature of an interest-only loan is that, when the interest-only period ends, the consumer's payments will increase dramatically. This fact is likely to be far more important to consumers than the mere fact of an interest-only period. The interest-only disclosure should be revised to include this essential fact. As noted earlier in these comments, we also suggest including this fact in the "Key Questions to Ask About Your Mortgage" flyer.

d. *Negative Amortization*

We support the Board's decision to require a special disclosure, in a plain language format, if a loan may negatively amortize even though the consumer makes the required payments. The obscurity of the disclosure of negative amortization under the existing rules clearly facilitated the spread of these highly risky loans.

As to phrasing of this disclosure, we urge the Board to test consumer comprehension of the term "negative amortization" when used as part of a disclosure that includes some explanation. While "negative amortization" is a technical term, the Board's consumer testing suggests that consumers may understand it when it is presented with an explanation.[175] One benefit of this term is that it is short—just two words instead

[175] *See* Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 56 (July 16, 2009) ("While few participants had previously heard the phrase "negative amortization," almost all understood that if this disclosure were true they could potentially end up owing more money than they had originally borrowed").

of an explanatory phrase. The word "negative" also gives it a slightly sinister connotation. Working this term into the plain language disclosure might improve consumer comprehension. The Board should also consider using the term in the "Key Questions to Ask About Your Mortgage" flyer.

In addition, we urge the Board to require a prominent disclosure of the fact that the consumer's payments will increase substantially once the negative amortization period ends—a fact likely to be much more important to consumers than the mere fact of negative amortization. The Board should not assume that consumers will deduce this fact on their own. It should be spelled out in clear and unmistakable language.

We also strongly urge the Board to harmonize this disclosure with the loan type disclosure it is proposing that be provided in the final disclosures. *See* Proposed Regulation Z § 226.38(a)(3)(i)(B), (C) and Section XII(F) of these comments. As we read Proposed Regulation Z § 226.19(b)(2)(i)(B), the ARM program disclosures must include the negative amortization disclosure whenever the minimum payments may cause negative amortization, even if the consumer has the option of making larger payments. The final disclosures, however, would require a loan to be labeled negative amortization only if the loan terms prohibited the consumer from making larger payments.

The Board is correct to treat a loan as negatively amortizing whenever making the minimum payments will lead to negative amortization, as it has done for the ARM program disclosures. It should be consistent and continue to treat such a loan as negatively amortizing for purposes of the loan type disclosures.

More fundamentally, however, disclosure is an inadequate approach. We urge the Board to impose substantive regulation upon payment option ARMs. Even after thirteen rounds of consumer testing, and many revisions of the disclosure forms, two out of nine participants failed to understand that their minimum payment would increase over time, and increase dramatically once the negative amortization period ended; two out of nine believed the minimum payment covered all the interest earned on the loan; and two out of nine failed to understand that making minimum payments would cause the loan balance to increase over time.[176] This poor result is particularly striking since almost all of these consumers had obtained a mortgage within the past two years and half had recent experience with ARMs. Consumers who are most vulnerable to abuse—those who have no recent experience in the mortgage market—were simply not represented.[177] In addition, consumers who could not give a "thoughtful, articulate answer" to a question about how they found their current mortgage lender were eliminated from the pool.[178] If this relatively sophisticated group of consumers had this level of misunderstanding after thirteen rounds of testing, it is plain that disclosure of this highly complex and counter-intuitive loan product is simply an ineffective approach. *See* § II.C.3, *supra*.

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[176] Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 70 (July 16, 2009).
[177] *Id.* at 3.
[178] *Id.* at Appx. B, Q5.

e. *Balloon Payment*

We support the requirement of a special disclosure of any balloon payment. Without a very prominent disclosure to the contrary, most consumers assume that their monthly payments will pay off their loans. (And this is not a misimpression that brokers hasten to correct.) Our only question about the Board's proposal is whether consumers will understand the meaning of the term "balloon payment" when it is presented without any explanation. (This is not a problem with the final TIL disclosure of the balloon payment, since in that disclosure the creditor is required to state the date and amount of the balloon payment. *See* Proposed Regulation Z § 226.38(d)(2)(iii); ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 55 (July 16, 2009).)

One way to work an explanation of the term "balloon payment" into the ARM program disclosure would be to refer to "balloon payment" in the question, but use a plain-language description in the answer. For example, the question and answer could be rephrased as:

> Will I owe a balloon payment?
> **YES**. A payment significantly larger than your regular payment will be due on _____.

f. *Demand Feature*

We support the Board's decision to continue to require disclosure if the loan has a demand feature, and to place this disclosure in the "Key Questions About Risk" table. A demand feature greatly increases the risk of a loan, and means that the consumer cannot rely on any of the loan terms continuing in effect. The language proposed by the Board for this disclosure is clear.

Nonetheless, we urge the Board to go beyond disclosure and prohibit mortgage loans from being due on demand. In the Board's consumer testing, several participants were surprised to find out that a demand feature was allowed in a mortgage loan.[179] When borrowers do not expect a loan to contain a certain term, they will not be on their guard for it, and a disclosure approach is particularly unlikely to be ineffective.

A demand feature in a mortgage loan makes the deal that the consumer has struck illusory, as the creditor has the option of nullifying the loan terms at any time. A demand feature also renders the APR disclosure relatively meaningless: if the creditor calls the loan after a short period, the actual APR will be higher than disclosed, since the closing costs will be spread out over a shorter period. The Board should prohibit demand features in mortgage loans.

[179] ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 79 (July 16, 2009).

g. *No-Documentation or Low-Documentation Loans*

The rapid spread of no-documentation and low-documentation loans during the peak of the subprime mortgage boom was a clear sign of a vast amount of irresponsible lending. With qualified borrowers already taken, the only way for brokers and lenders to keep originating loans was to make loans to unqualified borrowers. To retain market share, lenders abandoned responsible underwriting.

A critical feature of the no-doc loan boom was that many borrowers were unaware that their loans were no-doc loans. Nothing required lenders or brokers to disclose that they were providing the borrower a no-doc loan at a higher rate. In some cases, the borrower would in fact provide financial information, but the broker would still process the loan as a no-doc loan. For example, one lender published instructions on its website that brokers should obtain the borrower's Social Security statement and submit it, but with the income information blacked out.[180]

In its revised HOEPA rule and its new unfairness rule, Regulation Z §§ 226.34(a)(4), 226.35(b)(1), the Board has essentially outlawed no-doc and low-doc loans in the subprime market. The Board's new unfairness rules do not address no-doc and low-doc loans outside the subprime market, however. Requiring a disclosure that a loan is a no-doc or low-doc loan is an important step toward preventing these abuses in the prime market. However, we question whether disclosure alone will be sufficient to counteract the forces that caused the explosion in no-doc and low-doc loans.

In addition, we urge the Board to make clear, either in its final Section-by-Section Analysis or in the Commentary, that Regulation Z §§ 226.34(a)(4) and 226.35(b)(1) prohibit no-doc and low-doc loans in the subprime market. A cross-reference to these prohibitions would be a good precaution so that there would be no misapprehension that no-doc and low-doc subprime loans are allowed as long as the required disclosures are made.

We urge the Board to prohibit no-doc and low-doc loans in the prime market, or at least to narrow the circumstances in which they are allowed. For example, they could be allowed only where there were other strong and reliable indications, specified by the Board, that the loan was affordable. Preventing the mortgage market from blindly taking on the risks of unaffordable loans again is important not just for individual borrowers but also for the economy as a whole.

h. *Shared Equity or Shared Appreciation*

We have not seen many shared-equity or shared-appreciation loans. However, there is a great likelihood that loans with these uncommon terms will catch consumers unawares. The Board's proposal to require a special disclosure is therefore a well-advised step. We suggest, however, that the Board consider rephrasing the "Key Question" to read "Do I have to share any *home* equity I gain?"

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[180] *See* Appendix III, *infra,* Chevy Chase F.S.B.-Wholesale Lending Division, Loan Origination Guidelines.

We also urge the Board to consider whether other substantive restrictions should be imposed on these loans. It is telling that, in the Board's consumer testing, several participants were surprised to find out that shared equity or shared appreciation loans were allowed.[181] A disclosure approach is particularly likely to be ineffective when borrowers do not expect a loan to contain a certain term and are not on their guard for it.

To our knowledge, at present most shared equity or shared appreciation loans are offered by non-profit organizations and local governments as an affordable housing strategy, and we have no quarrel with this approach. Consumers obtaining mortgage loans from these organizations are likely to know that the loans have innovative features. Our concern is that this relatively benevolent loan product could be subverted if less scrupulous lenders saw it as a way to increase loan volume. At a minimum, we urge the Board to monitor the development of shared equity and shared appreciation mortgage lending, to assess whether substantive regulation is necessary.

7. Disclosure of Conversion Feature Should Be Retained, but a More Specific Disclosure Should Be Required After Application

The Board is proposing to carry over the existing rule's requirement that the creditor disclose the existence of a right to convert the transaction from adjustable to fixed rate. This disclosure must include a statement that the fixed interest rate may be higher than the adjustable rate at the time of conversion, a statement that conversion fees may be charged, and any interest rate or payment limitations that would apply. Proposed Regulation Z § 226.19(b)(1)(v).

We agree that this information is useful to consumers. However, it appears that, after the ARM program disclosures, the disclosure of the conversion feature simply vanishes. The Board does not require the creditor to provide a more exact description in the later disclosures, or even disclose whether the final loan terms include a conversion feature. It seems odd that a conversion feature is important enough to be included in the ARM program disclosures, but not important enough ever to be mentioned again.

8. We Support the Required References to the Board Website and the Availability of Housing Counseling

Proposed Regulation Z § 226.19(b)(3) requires the ARM program disclosure to refer consumers to the Board's website and to mention the availability of housing counseling. We support this new requirement.

Funneling more consumers into housing counseling might result in more informed mortgage borrowing. One major impediment to effective counseling about home mortgages in the past has been the rampant level of bait-and-switch tactics. Weak disclosure requirements have allowed creditors to present fundamental loan term changes

[181] ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 79 (July 16, 2009).

to borrowers at closing. This weak disclosure regime makes pre-closing mortgage counseling meaningless, as neither the counselor nor the consumer knows what loan terms the consumer will actually be asked to sign at closing. As discussed elsewhere in these comments, we strongly support the Board's proposal to require the exact final loan terms to be disclosed to the consumer three days before closing. Adoption of that proposal in the final rule is essential if the referring consumers to housing counselors is to be effective.

When the final rule is announced, we urge the Board to require the creditor to disclose a specific address for the page on the Board's website that contains the information in question. If consumers were referred to the Board's home page, they would probably find it a daunting task to locate the relevant information. Consumers should be given a web address that takes them immediately to the page with the relevant information. In addition, the reference to housing counseling should include HUD's automated 800-number for locating a housing counselor.

9. The Identity of Creditor and Loan Originator Should Be Disclosed

The Board has proposed that HELOC creditors be required to disclose their identities, including the loan originator's unique identifier under the SAFE Act, as part of the "early" HELOC disclosures. Proposed Regulation Z § 226.5b(c)(1). The Board is also proposing to require this information to be disclosed as part of the final closed-end disclosures. Proposed Regulation Z § 226.38(g). And it is considering requiring creditors to disclose their contact information as well as their identity. 74 Fed. Reg. 43,311, 43,459 (Aug. 26, 2009). Yet the Board does not appear to have proposed to require creditors or loan originators to disclose any identification information in the ARM program disclosures. Proposed Regulation Z § 226.19(b)(4)(iii) merely provides that the creditor "may make the heading disclosure using the name of the creditor and the name of the loan program." Identification of the creditor should be mandatory, as should provision of the loan originator's unique identifier.

10. The Proposed Loan Program Disclosures Provide Insufficient Disclosure of Payment Shock

The Board has solicited comment on whether there are other risk factors that the loan program disclosures should identify. 74 Fed. Reg. 43,232, 43,266 (Aug. 26, 2009). As discussed in more detail above, the main omission in the loan program disclosures is that payment shock is not sufficiently identified. Payment shock is inevitable with an interest-only or negative-amortization loan, yet the proposed disclosure does not make this clear. The proposed disclosure of the effect of a teaser rate on the consumer's payment is also very weak. Since the monthly payment is perhaps the most important piece of information for consumers, future payment shock should be much more clearly identified.

F. *The Board Should Set Bright-Line Rules Regarding Responsibility for Delivery of the Flyers and the Loan Program Disclosures*

The Board is proposing to continue a provision in the current regulation about whether a creditor can rely on an agent to deliver the flyers and loan program disclosures. Basically, if a "legal agent" of the creditor gives the consumer the loan application or accepts a non-refundable fee, that agent must give the consumers the disclosures at that point. However, if an "intermediary agent or broker" gives the consumer the loan application or accepts a non-refundable feet, then the creditor must send the consumer the flyers and loan program disclosures. The Board sets out a full column of factors and examples to determine how to categorize the person providing the loan application or accepting the fee. Proposed Official Staff Commentary § 226.19(d)(3)-3; 74 Fed. Reg. 43,232, 43,402–43,403 (Aug. 26, 2009).

As noted above, our experience and the Board's consumer testing suggest that creditors' compliance with the ARM program disclosure requirements has been poor. One contributing factor may be the lack of clear accountability for providing the disclosures. The complexity and imprecision of the standards for whether a person is an "intermediary agent or broker" makes it easy for each party—the creditor and the loan originator—to assume that the other is providing the disclosures.

We urge the Board to create a bright-line rule that places ultimate responsibility on the creditor in every case. One way to do this would be to require the creditor to mail the flyers and the ARM program disclosures to every consumer whose loan application was generated by someone other than an employee of the creditor. The result might be a duplicative mailing in many cases, but this requirement would create a fail-safe system that would ensure that the consumer got the disclosures.

VIII. SUBSEQUENT DISCLOSURES—§ 226.20[182]

A. *The Board Is Correct to Require Additional Time for ARM Adjustment Notices*

The Board proposes to extend the time for advance notice of an ARM rate adjustment by requiring creditors to give notice at least 60 days before the new payment amount is due. We support this change in Proposed Regulation Z § 226.20(c)(1) because the existing 25-day rule provides insufficient time for consumers to plan for payment changes. The current foreclosure crisis has proven that consumers have had great difficulty dealing with the payment shock associated with ARM mortgage products, particularly when the loan was made with an initial teaser rate. Recent reports from the Mortgage Bankers Association confirm that ARMs have significantly higher delinquency rates. For the third quarter 2009 reporting period, 16.72% of prime ARMs, and 40.80% of subprime ARMs, were seriously delinquent. During this same period, 4.29% of prime fixed rate mortgages, and 19.71% of subprime fixed rate mortgages, were seriously

[182] Discussion of the Board's proposal for subsequent disclosures for HELOCs is at Section IV of those comments, reprinted at Appendix I, *infra*.

delinquent.[183] Although additional notice of payment changes does not address the payment affordability issues driving the current foreclosure crisis, it can help some consumers recognize payment problems at an earlier time.

The Board has suggested that the additional notice of a rate change will give consumers the opportunity to refinance the loan if they cannot afford the adjusted payment. Of equal and perhaps greater importance in the current foreclosure crisis (and those of future times) is that the additional time can be used by the consumer to explore loan modification and loss mitigation options with the creditor or servicer. The proposal will also provide consumers with additional time before a payment change to pursue options under some mortgage contracts to convert an ARM to a fixed-rate mortgage.

B. *The Proposed ARM Adjustment Notices Are an Improvement But a Clarification of the Maximum Prepayment Penalty Disclosure Is Needed*

The Board is proposing several positive changes affecting the substance and format of ARM adjustment notices. We support the format changes set forth in the Adjustable-Rate Adjustment Notice Model Form (H-4(G)), and the addition of a table showing how payments are allocated among principal, interest and escrow amounts, as required by Proposed Regulation Z § 226.20(c)(2)((ii). The Proposed Model Clauses (H-4(H)) for disclosure of the new payment amount are also helpful. There are several other specific changes that merit further comment.

Proposed Regulation Z § 226.20(c)(2)(v) would require creditors to disclose on adjustment notices the maximum interest rate or payment over the life of the loan. We support this proposal but believe that it is important for budgeting purposes that consumers be informed of the maximum payment. Consumers are likely to underestimate the effect of an interest rate change on payments if only the maximum interest rate is given. Both maximum interest rate and payment over the life of the loan should be required to be disclosed. If the Board requires that only one of these items be disclosed, then we prefer that it be the maximum payment.

A significant proposed change is that adjustment notices shall include information about prepayment penalties. Proposed Regulation Z § 226.20(c)(4)(i) requires that the notice state the amount of the maximum penalty possible between the date the notice is sent and the last day the creditor may impose the penalty. We support this disclosure as it will assist consumers in making decisions about refinancing, including the timing of such transactions so as to avoid or limit prepayment penalties. However, we believe the proposal needs further clarification and refinement.

The Board should clarify whether the maximum prepayment penalty amount to be disclosed is determined by application of the prepayment contract clause at the time the notice is sent. If the mortgage contract provides that the prepayment penalty is based on a percentage amount of the principal amount prepaid, such as five percent of the principal

[183] *See* National Delinquency Survey from the Mortgage Bankers Association, Third Quarter 2009 (Sept. 30, 2009).

amount prepaid in the first year declining by one percent per year until the fifth year, we assume the maximum penalty amount to be disclosed in an adjustment notice sent in the second year would be based on the contract provision applicable at that time, which would set the prepayment penalty at four percent of the principal amount prepaid. However, application of the rule is not so clear when the prepayment penalty is based on a formula related to finance charges. If the amount of a penalty is tied to the applicable note interest rate, it is not clear whether the creditor should disclose the maximum prepayment penalty based on the applicable adjusted interest rate at the time of the notice or the maximum rate possible over the term of the prepayment penalty period.

If the disclosure is to be based on the contract provisions applicable at the time the notice is sent, we urge the Board to conduct consumer testing about the specific proposed disclosure. We are concerned that the time period used for the maximum penalty disclosure may lead to consumer confusion. By requiring that the maximum penalty possible between the date the notice is sent and the last day the creditor may impose the penalty be used, some consumers may assume that the prepayment amount is fixed for that entire period and does not change over time despite contract provisions to the contrary.

For example, if a consumer has a $300,000 ARM which has just adjusted to a 6.5% interest rate, and the mortgage contract provides for a prepayment penalty during the first three years based on a formula of 80% of one-half of the annual finance charge, the maximum prepayment penalty at the time the notice is sent may be in the amount of $7,800. If the contract rate adjusts to 8.0% a year later, the maximum prepayment penalty at that time may be in the amount of $9,600. Under the Board's proposal, however, the adjustment notice sent to the consumer during the first year in October 2009 would state: "If you pay off your loan, refinance or sell your home before May 1, 2012 you could pay a prepayment penalty of up to $7,800." We are concerned that some consumers reading that statement may misconstrue it to mean that the $7,800 penalty amount would remain constant during the entire prepayment period and not increase or decrease.

Consumer testing should be conducted to determine if consumers would benefit by a statement which discloses the maximum prepayment penalty between the date the notice is sent and the last day of the payment change period.

C. *The Current Index Value Should Not Be Deleted from ARM Adjustment Notices*

Creditors are currently required to disclose the index values upon which the prior and new interest rates are based. Proposed Regulation Z § 226.20(c)(2)(iii) would eliminate the requirement to disclose the index values. The Board has taken this position based on consumer testing which apparently revealed that some participants had difficulty understanding the relationship between the index, a margin and an interest rate. We request that the Board partially reverse this position and continue to require disclosure of the new index value.

Without a disclosure of the new index value, consumers who do understand the relationship between the index and margin are deprived of information needed to determine whether the servicer has applied the contract terms and correctly calculated the new interest rate. When servicing rights on mortgage loans are transferred and the loans are "boarded" with the new servicer, errors occasionally occur with the new servicer improperly entering the margin or appropriate index in the automated servicing system. If the new index value used by the servicer is disclosed, servicing errors have at least some chance of being discovered by the consumer. As the Board has recognized, consumers who prefer more information can review the loan agreement to determine the margin and the relationship between the index and margin. The task of verifying the servicer's calculations and its selection of the proper index rate is made much more difficult if the consumer is not given the index rate used by the servicer.

We believe that the new index value upon which the rate is based should be disclosed and that it can be done in a manner that will not confuse consumers or detract from the proposed model statement. For example, the index could be added at the end of the interest rate statement on the proposed model forms as follows:

> **Interest Rate:** Your interest rate will change due to an increase in the 1-year LIBOR index to 2.75%.

D. ***The Proposed ARM Adjustment Notices Should Include Additional Information***

Proposed Regulation Z § 226.20(c)(4)(ii) requires the creditor to disclose on the adjustment notice the phone number to call for additional information about the consumer's loan. We support this change but believe that a phone number alone is not sufficient because consumers routinely have problems contacting a responsible person who can provide account information or resolve disputes using servicers' phone systems. Too often consumers are bounced from one servicer representative to another after spending long periods of time on the phone and still never receive an answer. Adjustment notices should therefore also include the address where consumers can send written inquiries.

In the vast majority of cases, adjustment notices will be prepared and sent by mortgage servicers on loans covered by RESPA. As such, the servicer actions are subject to the information disclosure and dispute procedures found in 12 U.S.C. § 2650(e). The consumer has the right under this provision to send a qualified written request which may seek information and dispute account errors. We urge the Board to require that adjustment notices sent by servicers on mortgages covered by RESPA include a statement informing the consumer of the right to send a qualified written request. Adjustment notices provide an excellent opportunity to inform and remind consumers of this important right.

Regulation X provides that a servicer can establish, upon notice to the consumer, a separate and "exclusive" office and address for receipt and processing of qualified written requests. Regulation X, 24 C.F.R. § 3500.21(e)(1). Failure to send a qualified

written request to the exclusive address may preclude the servicer's compliance under 12 U.S.C. § 2605(e). Thus, if the servicer discloses on the adjustment notice an address for written inquiries in addition to the required phone number (whether or not required by the Board), and the servicer has designated an exclusive address for receipt of qualified written requests, the Board should require that the address disclosed on the adjustment notice should be that exclusive address.

E. *Periodic Statements for Payment Option ARMs and Negative Amortization Loans Should Be Required If the Board Does Not Ban Such Loan Products*

Proposed Regulation Z § 226.20(d) requires that periodic statements disclosing payment options be provided on certain closed-end loans secured by real property or a dwelling which permit the consumer to select among various payment options. The Board has recognized that payment option ARMs are complex transactions that are not understood by consumers. We applaud the Board's attempt to assist consumers with payment option choices, but do not believe that periodic statements, no matter how well crafted, can overcome the extreme complexity of these products. The contract terms for payment option ARMs are simply incomprehensible to average consumers, even with the aid of the proposed periodic statements.

We have strongly urged elsewhere in these comments that the Board should exercise its unfairness authority and ban these loan products. If the Board does not take this step to ban payment option ARMs, then we support that Board's action in requiring periodic statements. However, we urge the Board to do more consumer testing on whether the model forms actually improve consumer understanding and whether additional changes could increase consumer awareness.

The most important information to be conveyed on the periodic statement should be the fully amortizing payment. We support the Board's attempt to highlight the "Full Payment" on the Proposed Model Form (H-4(L)) but believe it should be made even more conspicuous. In addition, the periodic statement should indicate the total principal balance owed as well as the amount the balance has increased since loan origination. We also urge the Board to expand the proposal beyond payment option ARMs and require that negative amortization monthly statements be provided for all loans that permit interest-only payments or payments that are not fully amortizing.

Proposed Regulation Z § 226.20(c)(3) deals with ARM adjustment notices provided when a rate adjustment is not accompanied by a payment change. The proposed annual notices (Model Form H-4(K)) would apply in the early years of most payment option ARMs. Even when combined with the Board's proposal for negative amortization periodic statements, these disclosures are not sufficient to deal with the problem of consumers being lulled into a false sense of complacency by the steady payment amount and ultimately being unable to deal with the payment shock caused by the unexpected increase in the principal amount. If the Board does not ban payment option ARMs, it should require that these annual notices disclose the maximum payment over the life of the loan. Requiring the maximum rate is not sufficient. The Board should also require

that in addition to the loan balance, the annual statement should state the amount the balance has increased since loan origination.

Proposed Official Staff Commentary § 226.20(d)(1)(ii)-1 provides that because the disclosures on periodic statements must be consistent with the legal obligation, a creditor should not disclose that making fully amortizing payments on an interest-only loan will reduce a consumer's loan balance if the creditor will not apply such payments to principal. The Board should delete this comment and instead should prohibit contract terms on interest-only loans that do not give the consumer the option to have payments that exceed the interest-only payment applied to principal. For existing loans with such contract terms, the Board should require that the periodic statement for interest-only loans contain a clear warning that excess payments will not be applied to principal and a disclosure of exactly how excess payments will be treated.

F. ***The Board Should Require Periodic Statements for All Home Secured Loans***

In discussing the periodic statement requirement for payment option ARMs in Proposed Regulation Z § 226.20(d), the Board noted that it had considered but ultimately rejected requiring periodic statements for all loans secured by real property or a dwelling. The Board stated that because the consumer cannot exercise any choice in payments for loans other than payment option ARMs, it was not clear that the benefits of providing such statements for all loans outweighed the costs. This ignores the benefits gained from periodic statements that do not relate to payment choices.

Periodic statements provide a helpful reminder to consumers about the monthly payment due date, the cost of late fees, and the date to avoid imposition of a late fee. They also facilitate the payment process and prompt posting of payments because they typically include a tear-off enclosure used by the consumer when making payments which includes the servicer's lock-box payment address. Periodic statements also provide information to the consumer on a regular basis as to how payments have been applied and importantly whether payments have been applied to charges other than interest, principal and escrow deposits.

Many servicers currently provide periodic statements on mortgage accounts, no doubt based on their experience that such statements and tear-off coupons improve payment performance. The alternative to periodic statements is pre-printed coupon books. It is not clear that coupon books provide significant savings for servicers. For ARMs and mortgages with escrow accounts, there are frequent payment changes that would require printing and sending new coupon books at least annually, or every six months. If there is any cost benefit to the use of coupon books, it would be limited to fixed rate, non-escrow mortgage accounts which at present are not common.

It should not be assumed that <u>all</u> mortgage borrowers receive either a monthly statement or a coupon book. While many do, it is by no means universal. Borrowers who do not receive one or the other have no way to verify the amount of their payment,

that payments are properly and timely applied, or that they are not charged for inappropriate late or other fees. For example, in a series of HOEPA cases in Maine, the lender testified at deposition that no statements or other documents are sent to borrowers following the loan closing, nor are borrowers provided a coupon book or other payment reminder. These borrowers have no means to verify receipt and proper application of their mortgage payments, which is particularly problematic since this lender often creates an escrow for payments which are disbursed for a number of months after which the borrower's payment obligation commences.[184]

We urge the Board to either require periodic states for all home secured loans or conduct a comprehensive cost-benefit analysis of this alternative.

IX. CREDITOR-PLACED PROPERTY INSURANCE—Proposed § 226.20(e)[185]

A. *Board Proposal Fails to Regulate Serious Abuses and Market Dysfunctions Involving Creditor-Placed Property Insurance*

1. Background: Prevalent Abuses

As noted in the Board's Section-by-Section Analysis, creditor-placed property insurance typically relates to automobile and home mortgage loans, and the volume of such premiums has increased significantly in recent years. 74 Fed. Reg. 43,275. The analysis mentions one abuse—the issuance of creditor-placed property insurance where the lender knew or should have known that the consumer already had insurance. *Id.*

The analysis fails to mention other serious creditor-placed property insurance abuses and fails to identify the underlying cause of the abuses—the perverse incentives involved when the creditor has the right to purchase insurance for the consumer. Unique market forces related to this insurance almost guarantee abuse unless there is strong regulation. Nevertheless, the Board proposal fails to use its unfairness authority to regulate any of the prevalent abuses.

2. Creditor-Placed Property Insurance Purchase Involves Serious Marketplace Dysfunctions

Creditor-placed property insurance creates unusual incentives leading to marketplace dysfunctions. The creditor or servicer determines when the product should be purchased, the nature of the product purchased, from whom it will purchase the product, and the price of the product. The creditor or servicer then purchases the product, requires the consumer to pay for it, and may require the consumer to finance the purchase through the creditor, with that loan secured by the pre-existing collateral.

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[184] Bordetsky v. Brewster, BCD-WB-RE-08-30 (Me. Business & Consumer Docket); Bordetsky v. Nixon, BCD-WB-RE-08-35 (Me. Business & Consumer Docket); Bordetsky v. Dunlap, BCD-WB-RE-08-36 (Me. Business & Consumer Docket), all cases filed in 2007 or 2008 and still pending.

[185] Discussion of HELOCs and forced-place insurance is in both this section and Section V of the HELOC comments, reprinted at Appendix I, *infra*.

The transaction lacks consumer choice. The consumer cannot even turn down the insurance if it is over-priced. Without a free market, there is no counter to creditor or servicer abuses. One possible counter—that the increased cost of the insurance makes the loan riskier for the creditor—does not even exist where the servicer purchases the insurance, which is typical for creditor-placed insurance for mortgage loans. The holder of the mortgage loan contracts with a third party—the servicer—to accept and account for consumer payments, deal with delinquencies and foreclosures, make payments from an escrow account, and to make sure the collateral is insured. The servicer does not participate in the loan's risk, but instead is paid a fee by the loan holder, retains fees it assesses the consumer for late payment and foreclosure, and can also profit handsomely from force placing insurance.

The servicer bears no risk of default, and in fact may profit more from the consumer's default than from the consumer's regular payment stream. The higher the premium, the more room there is for the insurer to offer benefits to the servicer (at the expense of the consumer). If the higher premium leads to default and foreclosure, that may lead to even higher payments for the servicer.

3. Marketplace Dysfunction Without Adequate Regulation Leads to Serious Consumer Abuse

Because of the marketplace dysfunctions described at VII.A.2, *supra*, and the lack of regulation, creditor-placed insurance involves a number of unfair practices, which consumers find it difficult to avoid. Because the creditor or servicer controls the transaction, insurers compete not on the basis of the lowest priced premium, but on the basis of providing the greatest benefit to the creditor or servicer. Perversely, the higher the premium, the more room there is for the insurer to please the creditor or servicer, with either cash payments or additional services offered to the creditor or servicer. This is reverse competition—insurers compete with each other to offer the *highest* priced policy, because then they can offer the most benefit to the creditor or servicer.

Benefits the creditor or servicer derives from the insurance can vary. Often it is in the nature of direct cash payments. The insurer can offer "rebates" that are never passed on to the consumers paying for the insurance, or simply pay the creditor or servicer a large "commission" or other kickback. Alternatively, the insurer can be affiliated with the creditor or servicer, so that the benefit goes to a shared parent company instead of to the creditor purchasing the insurance.

The insurer can also offer additional services or coverage to the creditor or servicer, such as default insurance as part of the creditor-placed coverage or a free service that monitors the voluntary insurance status of all the servicer's book of business, notifying the servicer if any policy lapses. The insurer can also offer the creditor or servicer discounted or free blanket coverage for other risks that would ordinarily be paid by the creditor or servicer.

The profits to be made from force-placing insurance will naturally lead some creditors and servicers to place unnecessary creditor-placed insurance. The creditor or servicer can force-place the insurance when the consumer's voluntary coverage has not lapsed, or when the servicer itself is in error in failing to pay the voluntary insurance out of an escrow account. Coverage can also be purchased in excess of the collateral's value, or flood insurance can be purchased where the credit agreement does not require the purchase of that coverage.

Consumer injury from excessively priced creditor-placed insurance is not limited to the fact that the consumer may be paying more money for less coverage. Force placement of this insurance can lead to the consumer's loss of the collateral—repossession of a vehicle or foreclosure on a home. Unregulated creditor-placed insurance practices lead to higher foreclosure rates.

4. Special Unfairness of Creditor-Placed Insurance Where Voluntary Insurance Is Paid Out of an Escrow Account

Perhaps the most unfair practice related to creditor-placed insurance occurs in situations where the consumer makes payments into an escrow account, and the servicer uses the escrow to purchase the consumer's voluntary property insurance. When the escrow account is deemed insufficient to pay the consumer's property insurance (either because of the consumer's non-payment, an inaccurate estimate of escrow disbursements, the servicer's decision to apply payments to late fees or other charges instead of the escrow, or just plain servicer error), the servicer has two choices. One choice is to advance the funds necessary to pay the voluntary insurance premium and later increase the monthly payments to account for the shortfall as part of the next annual escrow analysis. Another is to purchase an entirely new creditor-placed insurance policy, similarly increasing the consumer's payments, this time to account for the higher cost of the creditor-placed insurance.

Any disinterested party would always select the first option, as being the better option for the consumer and the creditor. The first option is superior for the consumer because the creditor-placed insurance is *more* expensive and offers *less* protection to the consumer.

The first option is also better for the creditor because the consumer's payments are lower with the voluntary policy, meaning the risk of default is lower. The risk of default is also lower with the voluntary policy after an insurance loss, because the voluntary policy will pay the consumer far more, putting the consumer in a better financial position to repay the loan than if creditor-placed insurance had been purchased.

The first option also has its advantages for the servicer. Keeping up voluntary insurance payments is less work for the servicer than force placing new insurance. Simply making regular escrow disbursements on an existing policy does not involve the additional steps a servicer must go through to place a new policy.

The first option is even required by the Real Estate Settlement Procedures Act if the borrower is current with payments. As long as the borrower's mortgage payment is not more than thirty days late, the servicer must pay escrow items such as taxes and insurance in a timely manner even if there are not sufficient funds in the escrow account to cover the items. *See* Regulation X, 24 C.F.R. § 3500.17(k)(2). A servicer cannot obtain force-placed insurance from another carrier in this situation, and must instead pay the insurance premium on the borrower's policy when due by advancing its own funds. Any escrow shortage or deficiency resulting from the advance is then paid by the borrower through an adjustment to future escrow payments following an escrow account analysis.

Servicers' ability to comply with this federal requirement is evidence that servicers can easily advance the premium for voluntary instead of force-placed insurance. Even where a federal law does not specifically require the servicer to advance the voluntary insurance premium, it is unfair for the servicer to instead advance a higher premium for force-placed insurance, where that insurance is far worse for both the consumer and the creditor.

While keeping up voluntary insurance (despite the alleged escrow shortfall) is the better option for all the parties, and may be required by federal law, servicers nevertheless opt instead to force place more expensive insurance with less coverage. The reason the servicer disregards the consumer's and creditor's interests is that force placing insurance provides a healthy kickback or other benefit to the servicer. It is thus not surprising that servicers sometimes force place coverage even when the escrow account should have sufficient funds to pay for the voluntary insurance and even when they are required to advance funds under RESPA for borrowers who are current. Shoddy accounting or misapplication of payments that shortchanges an escrow account, or disregard of RESPA requirements, directly benefits the servicer.

5. Creditor-Placed Insurance Offers Far Less Protection Than Voluntary Coverage

Creditor-placed insurance is not just priced non-competitively. The coverage is less extensive than voluntary insurance, and consumers are often confused as to the amount of protection being offered—which can even lead to the consumer violating state law or otherwise being seriously under-insured.

Single interest creditor-placed insurance offers coverage only up to the loan amount, and offers no protection for the consumer's equity in the collateral. In the case of a *partial* loss, single interest insurance may provide *no* funds to repair the collateral, but will only pay the creditor, who may only reduce the loan's principal and not release any funds to the consumer for repairs.

Creditor-placed homeowners insurance provides *no* contents insurance, while voluntary insurance typically includes contents insurance as a standard part of the policy. Similarly, creditor-placed insurance will not be replacement insurance, while voluntary

insurance often is. Creditor-placed insurance covering a home or motor vehicle also will not include liability coverage, even though automobile liability insurance is compulsory in many states.

Moreover, there is much consumer confusion as to the extent of creditor-placed coverage, and this confusion injures not only the consumer, but the public at large. For example, consumers may not purchase automobile liability coverage when they assume that it is included in creditor-placed coverage. This damages not only the consumer, but any person injured in an accident with the consumer.

6. Only Exercise of the Board's Unfairness Authority Can Prevent Abusive Mortgage Creditor-Placed Insurance Practices

The Truth in Lending Act, 15 U.S.C. § 1639(*l*)(2), provides that the Board by regulation or order *shall* prohibit unfair or deceptive practices in connection with mortgage loans. As described *supra,* perverse incentives are created where the creditor or servicer decides whether to purchase insurance, the creditor or servicer selects the insurance, the insurance is for the benefit of the creditor, the creditor or servicer finances the premium, and the premium is paid by the consumer. Too often these incentives lead to unfair or deceptive practices, such as force-placing coverage even though the voluntary insurance has not lapsed, force-placing coverage when retaining voluntary insurance is the better option, selecting the most expensive creditor-placed insurance because of higher kickbacks to the creditor or servicer, and force-placing coverage not authorized by the contract.

Where the market is not operating properly and where there in fact is reverse competition, it is imperative that the Board use its statutory authority to prohibit practices that are unfair or deceptive. The unique marketplace forces at play here guarantee that such practices will continue unless checked by regulation. And, most importantly, the Board's failure to regulate unfair and deceptive mortgage creditor-placed insurance practices directly leads to higher foreclosure rates.

B. *Recommended Mortgage Creditor-Placed Insurance Provisions Under the Board's Unfairness Authority*

Pursuant to 15 U.S.C. § 1639(*l*)(2), the Board should proscribe the following unfair and deceptive practices related to mortgage creditor-placed property insurance:

1. Use Unfairness Authority to Prohibit Creditor-Placed Property Insurance Where a Mortgage Escrow Account Has Been Established to Purchase Voluntary Property Insurance

As detailed earlier in this section, there is no justification for a servicer to force-place insurance when the servicer has already been purchasing voluntary insurance for the consumer. Even if the escrow account does not have sufficient funds to make a voluntary insurance premium payment, the servicer can separately assess that premium as

part of future mortgage payments. The alternative is to separately assess an even higher creditor-placed insurance premium as part of future mortgage payments.

Creditor-placed insurance involves more work for the servicer, more cost for less coverage for the consumer, and more risk for the mortgage note holder. The only motivation for a servicer to force-place insurance in this context is to take unfair advantage of the situation to obtain excessive profit at the expense of the consumer and the mortgage note holder.

A servicer may have a fiduciary duty to continue voluntary instead of force-placed insurance where the servicer had been purchasing such insurance from escrow funds. Even if that duty does not exist, it is still an unfair practice to purchase creditor-placed insurance in this context. The servicer has taken advantage of a situation where there is no consumer choice or marketplace correction to force-placed inferior, expensive insurance solely to add to servicer profit.

Sometimes the creditor-placed insurance will be less expensive than the voluntary insurance, because its coverage is so much less. Even in this situation, if the servicer had been making voluntary premium payments from the escrow account, the servicer should not force place the insurance unless the consumer affirmatively consents. Because the servicer's incentives so often lead to abuse, the consumer should have the opportunity to make an informed decision whether to accept the lower priced force-placed insurance or the higher priced voluntary insurance that offers far more protection.

There is one exception in this context where the servicer should be allowed to force place coverage. The servicer cannot be expected to continue voluntary insurance payments where the insurer has cancelled the voluntary policy or refused to renew it. However, even in this circumstance, forced placement of insurance should be allowed only if the servicer has made a good faith effort to obtain alternative, market-priced voluntary insurance.

2. Declare Unfair That the Consumer (Instead of the Insurer and Creditor or Servicer) Bear the Cost of Duplicative Coverage

As the Board's Section by Section analysis indicates, "In some instances, creditors have improperly obtained property insurance when they arguably knew or should have known that the consumer already had insurance. [citations omitted]" 74 Fed. Reg. 43,275. Proposed Regulation Z § 226.20(e)(2) provides very modest protection from this abuse, allowing the consumer to avoid creditor-placed insurance premiums if the consumer provides evidence of insurance within 45 days of the Regulation Z § 226.20(e)(3) notice.

Proposed Regulation Z § 226.20(e)(2) does not deal with the common situation where, after the creditor-placed insurance goes into effect, it is discovered that the consumer had voluntary insurance overlapping with the creditor-placed insurance. In this

instance, who bears the cost of the creditor-placed premium—does the consumer pay twice or only once?

The clear answer is that it is unfair for the consumer to pay for creditor-placed insurance for the period where the consumer has voluntary coverage in force. Proposed Regulation Z § 226.20(e)(2) should be revised to state that it is unfair for a creditor to assess the consumer (or retain a consumer's payment) for that portion of the creditor-placed insurance premium covering a period where the consumer presents evidence that voluntary insurance was in place. The same should be the case for any finance charge or late charges relating to the duplicative force-placed insurance. There are at least two reasons for this result.

First, if there is a loss during a period of duplicative coverage, the creditor-placed policy will not pay on a claim, since there is already pre-existing voluntary coverage, and the creditor-placed policy will almost certainly exclude coverage in such a situation. Thus, to the extent there is duplicative coverage, the creditor-placed coverage is illusory. As a result, the insurer is not prejudiced if it bears the cost of the duplicative insurance because it never pays out claims under the policy. The consumer on the other hand, is prejudiced, paying for coverage that does not exist.

Second, it is the creditor or servicer that has determined that the consumer did not have coverage, when the consumer in fact has voluntary coverage. (A servicer may even be the one who paid for the voluntary coverage out of the consumer's escrow account and still determines that coverage does not exist.) Consumers do not ask for the creditor-placed coverage—the creditor or servicer makes a determination that the consumer does not have voluntary coverage. The creditor's error can be a result of either negligence or malfeasance. If the consumer bears the burden of duplicative coverage, the creditor will be rewarded for such conduct. If the creditor or servicer bears the burden, it will not only reform its ways, but almost certainly will be able to charge back the premium to the insurer.

3. Use Unfairness Authority to Prohibit a Mortgage Creditor or Servicer from Purchasing Creditor-Placed Property Insurance from Itself or an Affiliate

Because a competitive marketplace does not exist and because the creditor or servicer has sole discretion in selecting an insurer, the creditor or servicer should not be able to select itself or an affiliated company as the creditor-placed insurance provider. While creditors and servicers will be able to evade such a provision to some extent by selecting unaffiliated insurers that provide large kick-backs, such a practice opens up the creditor or servicer to claims under other law. In addition, we also recommend *infra* that the Board enact regulations dealing with such kickbacks.

4. Declare Unfair and Deceptive a Creditor or Servicer's Placement of Insurance That Includes Coverage Not Required by the Contract

It is unfair and deceptive for a creditor to select creditor-placed insurance that includes coverage which the credit agreement does not otherwise require the consumer to purchase. For example, a consumer should not be asked to pay for default insurance as part of force-placed insurance, where that default insurance was not originally required in the contract.

The very representation that the creditor is replacing lapsed voluntary insurance is deceptive if part of the "replacement" policy is coverage not required by the contract. Placement of such coverage is also unfair because it is done without the consumer's authorization and without any basis in law or contract.

5. Declare Unfair Charges for Creditor-Placed Insurance That Are Not Bona Fide and Reasonable

Regulation Z utilizes "bona fide and reasonable" as a standard to distinguish appropriate and inappropriate fees. For example, "bona fide and reasonable" is the standard for determining if real estate-related fees charged at loan consummation can be excluded from the finance charge. Regulation Z § 226.4(c)(7). Credit history fees are allowed if bona fide and reasonable. Regulation Z § 2226.19(a)(1)(iii).

The same standard should be applied to determine whether creditor-placed insurance charges are allowable. As described *supra*, creditors and servicers have an incentive to purchase the highest priced insurance because this provides room for the insurer to provide kickbacks of one sort or another to the creditor or servicer. Creditor-placed insurance premiums should not include charges that are not bona fide and reasonable. For example, charging the consumer for default insurance as part of the creditor-placed property insurance would not be bona fide and reasonable.

6. Declare Unfair a Creditor or Servicer Receiving Free Services As Part of the Creditor-Placed Insurance, If Such Services Are Not Normally Provided for Voluntary Coverage

As a way of luring creditors to force place coverage with its company, an insurer may offer the creditor additional services as part of the insurance package. In effect, the consumer is paying for these services, even though a consumer with voluntary insurance need not pay for such services. For example, a creditor-placed insurer may track the creditor's total customer base, to identify when any of their customers' voluntary insurance lapses. This tracking service may be offered to the creditor or servicer for free, but paid for as part of the force-placed premium assessed to consumers.

It is unfair for a creditor to require a consumer to pay for such services where the original credit agreement does not require the consumer to pay for them and where such service is not included with voluntary insurance. The very representation that the

consumer is paying for coverage to substitute for lapsed voluntary coverage is deceptive if part of what the consumer is paying for is a service not required by the contract and for which the consumer has not agreed to pay. Requiring the consumer to pay for such services is illegal and unfair.

C. *Proposed Regulation Z § 226.20(e)'s Flawed and Inadequate Disclosure Proposal Should Be Strengthened*

1. Introduction

There is a stark contrast between the magnitude of unfair practices involving creditor-placed insurance and the minimal steps the Board is proposing to take. Proposed Regulation Z § 226.20(e) provides only for certain inadequate and flawed disclosures. Then, when coverage is in fact force-placed, Proposed Regulation Z § 226.20(e)(4) requires *only* disclosure that a policy exists, and does not even require a description of the policy's coverage and limitations compared to voluntary coverage. Although it is far more important to prohibit the unfair practices, as detailed in VII.B, *supra,* the proposed creditor-placed insurance disclosures should be strengthened.

2. The § 226.20(e)(3) Notice Should Include a More Specific Statement of Coverage Missing from the Creditor-Placed Property Insurance

Proposed Regulation Z § 226.30(e)(3)(viii) provides for a vague statement "that creditor-placed property insurance may not provide as much coverage as homeowner's insurance" Most obviously, this is not the proper disclosure for a motor vehicle loan. Even for a mortgage loan, this statement is totally meaningless to the average consumer, and conveys no useful information.

Instead, there should be two alternative disclosures—one for motor vehicle loans and one for mortgage loans. Both disclosures should be more specific as to the differences between voluntary and creditor-placed insurance, both to encourage the consumer to purchase voluntary insurance and so that consumers understand the consequences of the limitations of the creditor-placed coverage.

The notice for a mortgage loan should detail the following, *only if* applicable:

- Creditor-placed insurance provides no coverage for your home's contents.
- Creditor-placed insurance coverage does not provide you with funds to repair a partial loss.
- Creditor-placed insurance will not pay replacement cost, but will only pay up to the amount of the loan.
- Creditor-placed insurance provides no coverage for liability claims.

The notice for a motor vehicle loan should detail the following, *only if* applicable:

- Creditor-placed insurance coverage does not provide you with funds to repair a partial loss.

- Creditor-placed insurance will not pay replacement cost, but will only pay up to the amount of the loan.
- Creditor-placed insurance provides no coverage for either property damage or personal injury liability claims. State law may require you to purchase this coverage separately.

3. The Same Information Should Be Disclosed in the § 226.20(e)(4) Notice

Understanding the limits of creditor-placed insurance is important, and providing the information to consumers twice is certainly better than once. Some consumer may more carefully read a disclosure that a charge has been assessed (the 20(e)(4) notice), than a disclosure that a charge *may* be assessed if certain action is not taken (the 20(e)(3) notice).

4. In Additional Ways, the § 226.20(e)(4) Notice Is Totally Inadequate

Proposed Regulation Z § 226.20(e)(4) requires the creditor to send the consumer "evidence of the creditor-placed property insurance." The creditor need not send a copy of the policy—that is just one option. The creditor need not even say the consumer is paying for this insurance, or that it is being placed because the creditor believes voluntary insurance is not in place.

This disclosure is inadequate on a number of other grounds. It does not disclose again the cost of the insurance, it need not include the actual policy, and it does not disclose the specific limits of the policy (see § VII.C.2, *supra*.). It does not disclose that the consumer can obtain voluntary coverage and that this will result in a partial rebate of the creditor-placed premium, nor does this disclose how to provide evidence of this voluntary coverage.

The Board rejected proposing additional information in the Regulation Z § 226.20(e)(3) notice because it was concerned about "information overload." Whatever the merits of this conclusion, this cannot provide a basis for excluding necessary information from the Regulation Z § 226.20(e)(4) notice, which otherwise provides virtually no required information.

D. *HELOCs and Creditor-Placed Insurance*

The Board requests comments whether creditor-placed insurance requires the same regulation when written in conjunction with a HELOC as it does when written in conjunction with an automotive or closed-end home mortgage loan. The same market dysfunctions and perverse incentives exist for creditor-placed insurance, irrespective of the type of loan or loan collateral. That the consumer has the option to obtain additional credit does not change the fact that, for an existing loan, the same abuses can occur, whether the existing mortgage loan was obtained through a closed-end or an open-end plan.

A number of recommendations above rely on the Board's authority under 15 U.S.C. § 1639(*l*)(2). While certain other subsections of 15 U.S.C. § 1639 do not apply to HELOCs, § 1639(*l)*(2) defines its scope as "mortgage loans," which clearly includes HELOCs. Thus the same recommendations as to proscribing unfair and deceptive practices apply to HELOCs as to closed-end mortgage loans.

X. PROPOSED CHANGES TO HOEPA RULE—§ 226.32

A. *The Board's Proposed Amendment to the Points and Fees Trigger Is Appropriate But Needs Minor Revisions*

The Board proposes to revise Regulation Z § 226.32(b), the rule that defines "points and fees" for purposes of HOEPA, to conform it to the revised definition of the finance charge. The Board intends no substantive change by this revision. 74 Fed. Reg. 43,278.

In general, this revision is appropriate. The result will be a streamlined rule that eliminates distinctions that will no longer be relevant in light of the more inclusive definition of the finance charge.

However, we have one concern. At present, Regulation Z § 226.32(b)(1)(iii) provides that the term "points and fees" includes "[a]ll compensation paid to mortgage brokers." The proposed revision would incorporate Regulation Z § 226.4(a)(3), which provides that "*[f]ees charged* by a mortgage broker (including fees paid by the consumer directly to the broker or to the creditor for delivery to the broker)" are included in the finance charge. The former is a significantly broader phrase than the latter, as a broker may receive compensation through means other than charging fees.

Up-front mortgage broker compensation was one of the key drivers of the irresponsible lending that led to the subprime mortgage meltdown. Even though the Board is proposing to ban yield spread premiums, it can anticipate that mortgage brokers will devise other hidden ways to obtain compensation for making loans. Defining the HOEPA points and fees trigger in a more inclusive way is important as a means of preventing evasion of the HOEPA triggers. The Board has broad authority under 15 U.S.C. § 1602(aa)(4)(D) to expand the HOEPA definition of points and fees.

We therefore recommend that the Board either:

- Revise § 226.32(b)(1) to define "points and fees" as "*all compensation paid to mortgage brokers, whether or not payable by the consumer at or before closing, and* all items included in the finance charge pursuant to § 224.4, except interest or the time-price differential."

or

- Revise § 226.4(a)(3) to define the finance charge as including "*all compensation paid to a mortgage broker, whether or not payable by the*

consumer at or before closing,…" instead of "fees charged by a mortgage broker."

B. *The Board's Proposed Plain-Language Revision of the Advance Look Notice Is an Improvement, But Its Specification of a 10-Point Font Is Inadequate*

The Board proposes several revisions of Regulation Z § 226.32(c) regarding the content of the advance look notice for HOEPA loans. 74 Fed. Reg. 43,278–43,279.

First, the Board proposes to simplify the warning statement on the advance look notice. Proposed Regulation Z § 226.32(c)(1). We commend the Board for its continued attention to the understandability of disclosures. Too often, disclosures have been so complex and technical as to be meaningless to the average consumer. The Board's proposed rewrite is significantly shorter and much clearer. We also commend the Board for detecting that some consumers believed that signing the advance look notice amounted to acceptance of the loan, and for amending the notice to clarify that it does not.

Second, the Board proposes to treat charges for debt suspension coverage the same as charges for credit insurance or debt cancellation coverage. Proposed Regulation Z § 226.32(c)(5). We strongly support this proposal. First, as the Board has pointed out, debt suspension coverage, while it provides less protection to the consumer, nonetheless serves the same purposes as debt cancellation coverage. 74 Fed. Reg. 43,278. It would be illogical to require disclosure of the cost of the latter but not the former in connection with the advance look notice's statement of the amount borrowed. Second, if the Board did not require disclosure of the cost of debt suspension coverage, it would give creditors an incentive to move consumers into this less-desirable, under-the-radar product.

Finally, the Board proposes to require that the warning notice be in bold text and at least a 10-point font. Proposed Regulation Z § 226.32(c)(1). We support the Board's decision to specify boldface type, but a 10-point font is simply inadequate. A 10-point font is unlikely to be more conspicuous than other parts of the advance look notice, and will be difficult to read for many individuals. The Board should require the warning and the other key disclosures to be in at least a 12-point font. Additional discussion of the advantages of 12- over 10-point type is found at § XII.C.2, *infra.* The Board should require the warning and the other key disclosures to be in at least a 12-point font as part of ensuring that this material is obvious to consumers and not overshadowed or buried by other text.

XI. THE BOARD'S PROPOSALS REGARDING LOAN ORIGINATOR COMPENSATION AND STEERING ARE IMPORTANT STEPS TOWARD TRANSPARENCY IN PRICING.

A. Overview

Loan originator compensation has been one of the leading causes of distortions in the marketplace. We applaud the Board for its significant progress in restoring rationality to loan originator compensation.

We have long supported the idea of "no-cost" loans—loans where all the fees are pushed into the interest rate—as offering significant benefits for consumers and the market. We believe that "no-cost" loans are easier for consumers to price and shop and afford ample scope for generous compensation for loan originators. Because consumers are not confronted with complex, multivariate decision making in evaluating a "no-cost" loan, consumers are better able to avoid predatory pricing and pick a loan that matches their needs and risk profile. Racial disparity in pricing appears to vanish in no-cost loans.[186] "No-cost" loans are also simpler for creditors, loan originators, and regulators: because consumers can do a better job of policing the market when all the costs are in the interest rate, fewer rules are needed.

No-cost loans provide the proper incentives for originators and the secondary market. In a no-cost loan, the only money to be made is if the loan performs over time. Thus, no-cost loans give originators and the secondary market an increased incentive to make sure that underwriting is done at the time of origination. No-cost loans also reduce the incentive to strip equity by increasing the loan amount with junk fees. Such equity stripping does the consumer permanent harm and cannot be refinanced away, unlike a higher interest rate.

The Board's proposal moves the market toward making "no-cost" loans the standard method of compensation. To the extent that the Board accomplishes that goal, shopping will be made easier for consumers and competition among honest creditors should increase.

We believe the Board must go further in its proposals. It should ban compensation that is based on the size of the loan regardless of who pays the compensation, including the consumer. It should clarify and extend the prohibition against dual-source compensation. This regulation should promote an even playing field and regulate all loans, high-cost and prime, open- and closed-end. In accordance with existing guidance from the banking regulatory agencies, creditors must be made clearly responsible for the actions of loan originators, whether in-house or not. The Board should require records to be maintained for a minimum of five years and must ensure that the records maintained actually reveal the amount, calculation, and method of compensation. Finally, the steering rule, while important, must not allow loan originators to use disclosure to

[186] U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 2-43 (2008).

immunize themselves from the rule. Disclosure, as the Board recognizes, does not work for loan originator compensation.[187] Substantive regulation is required.

We join in the Center for Responsible Lending's more detailed comments on the Board's proposals to address loan originator compensation and steering.

B. Loan Originator Compensation Should Not Be Based on the Terms of the Loan, Including the Principal Amount

We strongly support the Board's proposed rule on loan originator compensation.[188] Lender-paid broker compensation has led to most of the major abusive lending practices observed over the last decade. The commission incentives, including percentage-based commissions, are all designed to encourage the broker to do something that is good for the lender and generally bad for the borrower. Pricing based on the terms of the loan has not encouraged responsible lending.

As the Board observes, "disclosure alone would be insufficient for most consumers."[189] We share the Board's recognition that even the recently revised disclosures issued by the Department of Housing and Urban Development under Regulation X are not sufficient to counteract the substantive unfairness and deliberate opacity of lender-paid broker compensation.[190] Prohibiting payment based on the loan's terms or rate[191] and prohibiting split pricing, where both the homeowner and the creditor compensate the originator, will do much to improve market transparency and fairness.

The Board's suggestion that loan originators might be compensated on the performance of the loans they originate is a welcome step forward.[192] To date, brokers have seldom had any incentive to look out for the borrowers' interest and make sure a loan is performing: once the loan is funded, brokers typically receive their compensation and move on.[193] In-house loan originators have occasionally had some incentive to make performing loans, but even there the incentive structure has been titled towards origination volume at the expense of quality.

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[187] 74 Fed. Reg. 43,232, 43,284 (Aug. 26, 2009).

[188] The Board uses the term "loan originator" to refer to both in-house loan officers and mortgage brokers. In final rules adopted last November, the Department of Housing and Urban Development (HUD) uses "loan originator" to refer to originating lenders and mortgage brokers. XX We would encourage the Board to coordinate with HUD for a single definition, to ease reference.

[189] 74 Fed. Reg. 43,232, 43,281 (Aug. 26, 2009).

[190] 74 Fed. Reg. 43,232, 43,281 (Aug. 26, 2009).

[191] The Board may wish to provide some additional clarity in its definitions. For example, proposed comment § 226.36(d)(1)-2 does not include existing common bases for compensation, including the margin or index used in a variable rate loan, or the time that payments or rate remain fixed.

[192] *See* 74 Fed. Reg. 43,232, 43,408 (Aug. 26, 2009) (proposed comment § 226.36(d)(1)-3).

[193] *See* Saunders v. Ace Mortg. Funding, Inc., 2007 WL 1190985 (D. Minn. Apr. 16, 2007) (discussing mortgage broker compensation in context of Fair Labor Standards Act claim; brokers compensated almost entirely on loan closing volume), *motion for interlocutory appeal granted*, 2007 WL 2008677 (D. Minn. July 6, 2007); William C. Apgar & Allegra Calder, The Dual Mortgage Market: The Persistence of Discrimination in Mortgage Lending 6 (Jt. Ctr. for Housing Studies, Harvard University, Working Paper W05-11 Dec. 2005), *available at* www.jchs.harvard.edu/publications/finance/w05-11.pdf.

1. Yield Spread Premiums and Other Creditor-Paid Loan Originator Compensation Have Been Leading Causes of Market Distortions and Abuse

Creditors make payments to loan originators because they want borrowers to be steered into some loans. Loan originators have, unsurprisingly, been responsive to these incentives, with the result that many homeowners have ended up with loans that did not reflect their needs or desires As the Center for Responsible Lending details in its comments, lenders have made payments to encourage the making of payment option ARMs as well as high-cost loans. Lender-paid loan origination compensation is decoupled from the amount of work a loan originator must do or the value provided a homeowner: brokers have been provided extra funds for making no-documentation or reduced documentation loans, even when the borrower has provided full documentation to the loan originator.

a. *Lender-Paid Broker Compensation Has Led to Unaffordable Loans and Inflated Pricing*

Loans originated by brokers, compared to loans originated directly by lenders, are more likely to default,[194] more likely to be adjustable rate mortgages, more likely to be stated-income loans,[195] and more likely to be based on fraud.[196] Broker-originated loans, at least in the subprime market, are usually more expensive for borrowers than lender originated loans.[197]

Why do brokered loans perform so much more poorly? In large part brokered-loans perform so poorly because brokers have no skin in the game. Instead of caring about the long-term performance of loans, brokers were responding to the incentives made available by creditors to make certain kinds of loans. As such, brokered loans are

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[194] William P. Alexander, Scott D. Grimshaw, Grant R. McQueen, & Barrett A. Slade, *Some Loans Are More Equal Than Others: Third-Party Originations and Defaults in the Subprime Mortgage Industry*, 30 Real Est. Econ. 667 (2002).

[195] Edward Golding, Richard K. Green & Douglas A. McManus, Imperfect Information and the Housing Finance Crisis 10 (Feb. 1, 2008), *available at* www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-6_golding_green_mcmanus.pdf.

[196] BasePoint Analytics, White Paper: Broker-Facilitated Fraud—The Impact on Mortgage Lenders 2 (2006–2007) ("[T]he most serious mortgage fraud risk is broker-facilitated fraud.").

[197] *See* Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-24 to 2-43 (2008) (reviewing the literature); Keith Ernst, Debbie Bocian & Wei Li, Ctr. for Responsible Lending, Steered Wrong: Brokers, Borrowers, and Subprime Loans (2008), *available at* www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf (borrowers in the subprime market pay more when there is a broker). *Cf.* Susan Woodward, *A Study of Closing Costs on FHA Mortgages*, U.S. Department of Housing and Urban Development, Office of Policy Development and Research. (2008), *available at* http://www.urban.org/UploadedPDF/411682_fha_mortgages.pdf (reporting data showing that borrowers on FHA loans pay more in interest, broker fees, and other closing costs when the broker is paid both by the borrower and the lender, as most brokers in the subprime market are).

the clearest example of the distortions that lender-paid loan originator compensation can introduce.

Borrowers are often overcharged in two separate ways by brokers: once for the broker's services and once through increased interest rates. In the subprime market, borrowers on average pay more, as measured by the loan's APR, for having a loan brokered.[198] Mortgage borrowers with credit (FICO) scores below 600 pay significantly more in interest for brokered loans than for loans originated directly by lenders.[199] This holds true regardless of the debt-to-income or loan-to-value ratios.[200] Even in the prime market, borrowers often appear to pay more in costs and APR for brokered loans than for loans originated directly by a lender.[201]

As HUD has described, lender-paid broker compensation often leads to higher settlement costs and higher broker costs, as well as higher interest rate costs.[202] In most circumstances, borrowers receive little, if any benefit, from lender-paid broker compensation. While the borrower may have some reduction in upfront costs for broker compensation and settlement costs when there is lender-paid broker compensation, such reduction is seldom one-for-one and is often as low as twenty-five cents for every dollar of lender paid broker compensation.[203] Only where the fees are either all in or all out of

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[198] A study of 2004 and 2005 prime and subprime loans found that on average, both in the prime and subprime market, borrowers had a higher APR if the loan was brokered than not. The one exception was for 2004 subprime loans when the APR was 0.08 percentage points lower for a brokered subprime loan versus a retail subprime loan. The highest premium on brokered loans was 0.31 percentage points in the APR for 2005 subprime loans. Marsha J. Courchane, *The Pricing of Home Mortgage Loans to Minority Borrowers: How Much of the APR Differential Can We Explain?*, 29 J. Real Est. Res. 399, 416, 418, 430(2007). *See also* Keith Ernst, Debbie Bocian & Wei Li, Ctr. for Responsible Lending, Steered Wrong: Brokers, Borrowers, and Subprime Loans (2008), *available at* www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf (prime borrowers sometimes save by using a broker but the magnitude of their savings is small compared to the costs imposed on borrowers in the subprime market); *cf.* Michael LaCour-Little, Economic Factors Affecting Home Mortgage Disclosure 24 (May 18, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=992815 (loans originated by brokers were, after controlling for other economic factors, significantly more likely to have increased APRs from 2004 to 2005 than loans originated directly by lenders).

[199] Keith Ernst, Debbie Bocian & Wei Li, Ctr. for Responsible Lending, Steered Wrong: Brokers, Borrowers, and Subprime Loans (2008), *available at* www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf.

[200] *Id.*

[201] *See* Marsha J. Courchane, *The Pricing of Home Mortgage Loans to Minority Borrowers: How Much of the APR Differential Can We Explain?*, 29 J. Real Est. Res. 399, 416, 418, 430 (2007) (finding that prime borrowers in 2004 and 2005 had a higher APR for brokered loans than for retail loans); Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 Stan. J.L. Bus. & Fin. 289, 332 (2007) (borrowers in a survey of over 3000 prime loans pay on average $869 more in costs to have a loan brokered).

[202] Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-24 to 2-43 (2008).

[203] Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 Stan. J.L. Bus. & Fin. 289, T. 6 (2007) (average borrowers' fees reduced by 25 cents for every dollar the broker paid through a yield spread premium, compared to loans without a yield spread premium). *Cf.* Keith Ernst, Debbie Bocian & Wei Li, Ctr. for Responsible Lending, Steered Wrong: Brokers, Borrowers, and Subprime Loans 30 (2008), http://www.responsiblelending.org/pdfs/steered-

the rate are consumers able to shop successfully for the cheapest loan. When consumers can compare loans with the fees all in or all out, consumers are able to shop based on their preference for a higher rate, if they are likely to be refinancing or selling relatively soon, or higher fees, if they have cash or, more commonly, equity to spare.

b. *Lender-Paid Broker Compensation Has Contributed to Racially Disparate Pricing*

African-Americans and Hispanics are particularly overcharged by brokers.[204] Evidence shows that Latinos and African Americans pay even more for loans originated through brokers than whites pay and are more likely to be overcharged for brokered loans than loans originated directly by the lender without a broker.[205]

The mechanics and extent of lender-paid broker compensation reach beyond simply overcharging African-American and Latino borrowers. Lenders use broker compensation to lock African-Americans and Latinos into downwardly mobile borrowing and destructive products. For example, lender payments to brokers have often been conditioned on the borrower's acceptance of a prepayment penalty.[206] Thus, brokers have an incentive not only to put borrowers into a high cost loan in order to receive additional compensation from the lender, but to make sure the borrower is locked into the high cost loan. Prepayment penalties in these circumstances are seldom chosen by the borrower or in the borrowers' interest.[207]

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wrong-brokers-borrowers-and-subprime-loans.pdf (borrowers with FICO scores of 640 and below pay, on average, $3146 more over four years for every $100,000 borrowed, or roughly an additional 3% of the loan amount).

[204] Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 Stan. J.L. Bus. & Fin. 289, 350 (2007).

[205] *See* Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *Higher Priced Home Lending and the 2005 HMDA Data*, Fed. Reserve Bull. A123, A157–A158 (2006), *available at* www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf (pricing disparities between whites and minorities highest for broker originated loans); Robert B. Avery & Glenn B. Canner, *New Information Reported Under HMDA and Its Application in Fair Lending Enforcement*, Fed. Reserve Bulletin 344, 380, 394 (Summer 2005), *available at* www.federalreserve.gov/pubs/bulletin/2005/3-05/hmda.pdf (same); Press Release, Office of the New York State Attorney General, Countrywide Agrees to New Measures to Combat Racial and Ethnic Disparities in Mortgage Loan Pricing (Dec. 5, 2006), *available at* www.oag.state.ny.us/press/2006/dec/dec05a_06.html (pricing disparities between whites and minorities highest for broker originated loans). *Cf.* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. for Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 21–23 (May 31, 2006), *available at* www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (discussing evidence and analysis that links pricing disparities with broker activity and incentives).

[206] *See* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 21 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (noting that payment of yield spread premiums is often conditioned on the imposition of a prepayment penalty).

[207] Loans with prepayment penalties attached have higher rates of foreclosure, and in brokered loans, borrowers generally receive no interest rate reduction in exchange for the imposition of the prepayment penalty. *See, e.g.,* Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures—Distinguishing Impacts by Loan Category 45 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf

Lender-paid broker compensation created the incentives that drive much of the racially disparate pricing.[208] By encouraging brokers to overprice loans where and when they can, lenders implicitly encouraged brokers to target the vulnerable and gullible and those perceived as vulnerable and gullible. And African-American and Latino borrowers are particularly likely to believe that their lenders are required to give them the best rate they qualify for. [209]

c. *Loan Originator Compensation Cannot Be Adequately Disclosed*

Most disclosures of lender-paid loan-originator compensation confuse consumers, both because the tradeoffs are inherently complex and because borrowers are led to believe erroneously by both brokers and originators that brokers act as the borrowers' agents.

In recent years, the Federal Trade Commission,[210] the Department of Housing and Urban Development, and the Federal Reserve Board have all encountered significant hurdles in designing a workable disclosure of loan originator compensation. HUD, for example, in designing its new Good Faith Estimate, went through six rounds of consumer testing, but could only produce a workable form by grossly simplifying the tradeoffs. HUD asked borrowers to choose between two loans that varied only by the total amount

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(prepayment penalties and balloon notes combined on a fixed rate refinance subprime loan increase the rate of foreclosure 227%); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 21 (Dec. 2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf (higher risk for foreclosure for adjustable rate loans, loans with balloon payments, loans with prepayment penalties, and limited documentation); Gregory Elliehausen, Michael E. Staten & Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages* 15 (Sept. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_79_elliehausen_staten_steinbuks_preliminary.pdf. (finding that prepayment penalties were associated with higher interest rates unless they controlled for "borrower income, property value, loan amount, whether the loan was originated by a broker, and type of interest rate," in which case the difference shrank). *See also* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 3–4 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (the presence of a prepayment penalty increased the likelihood that African Americans had a higher cost subprime loan as compared to whites).

[208] Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 21–23 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (discussing evidence and analysis that links pricing disparities with broker activity and incentives). *See also* Press Release, Office of the New York State Attorney General, Countrywide Agrees to New Measures to Combat Racial and Ethnic Disparities in Mortgage Loan Pricing (Dec. 5, 2006), *available at* http://www.oag.state.ny.us/press/2006/dec/dec05a_06.html (pricing disparities between whites and minorities highest for broker originated loans).

[209] Mortgage Foreclosure Filings in Pennsylvania: A Study by The Reinvestment Fund for the Pennsylvania Department of Banking 74 (Mar. 2005), *available at* http://www.trfund.com/policy/pa_foreclosures.htm, *citing* Fannie Mae's 2002 National Housing Survey.

[210] James M. Lacko & Janis K. Pappalardo, Fed'L Trade Comm'n, The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment (2004), *available at* http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf.

of settlement costs. Otherwise, the loans were identical: the same loan terms, the same loan amount, the same interest rate, the same monthly payment. No testing was done comparing the cost of loans when the interest rate changed as a result of lender-paid broker compensation.[211] As a result, the testing could not produce a form that allowed borrowers to compare loans that vary in the ways that real-life loans always do.

Given most consumers' limited ability to manipulate percentages and interest rates, juggling both interest and fees in making a cost decision is clearly beyond all but the most financially sophisticated consumers.[212] Most consumers cannot calculate interest.[213] When borrowers are forced to compare loans with disaggregated fees, even when the interest rate is the same, more than a third cannot identify the cheaper loan.[214] Only at the point when all the fees are pushed into the interest rate can most consumers intelligently evaluate the costs of trading fees for interest,

The economic realities of these tradeoffs can never adequately be disclosed to borrowers. Confusion results in overpayment: empirically, lender-paid broker compensation increases all fees and does not reduce one-for-one the borrower's costs. Homeowners pay more when they must shop both on fees and rate, regardless of disclosure.[215]

The limits of disclosure are compounded by borrower's misplaced trust in their loan originators. As the Board's testing reveals, borrowers trust their loan originators. Borrowers identify finding a loan originator they trust as the one of the most important

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[211] A final test did assume a difference in interest rate and YSP—but borrowers were not asked to choose the cheapest loan in this example—only compare the GFEs to the final settlement statement for discrepancies.

[212] For a review of the quantitative literacy studies on this point, see Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth, and Nothing But the Truth: Fulfilling the Promise of Truth In Lending*, 25 Yale J. on Reg. 181 (2008).

[213] Only 22% of the adult U.S. population in 1992 could even describe how to calculate interest, given a stream of payments, an amount borrowed, and a total loan amount, according to the 1992 National Assessment of Adult Literacy. The question and results are available at http://nces.ed.gov/NAAL/SampleQuestion.asp?NextItem'0&AutoR'2. Macro International, Inc., Design and Testing of Effective Truth in Lending Disclosures 9, 26 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf (borrowers have difficulty calculating interest); Danna Moore, Survey of Financial Literacy in Washington State: Knowledge, Behavior, Attitudes and Experiences 27 (Technical Report 03-09, Soc. & Econ. Sci. Research Ctr., Wash. State Univ., 2003), *available at* http://www.dfi.wa.gov/news/finlitsurvey.pdf (same); Annamaria Lusardi & Olivia S. Mitchell, *Baby Boomer Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth*, J. Monetary Econ. (forthcoming) (manuscript at 34), *available at* http://www.dartmouth.edu/~alusardi/Papers/BabyBoomers.pdf. (same); Annamaria Lusardi & Olivia S. Mitchell, Financial Literacy and Planning: Implications for Retirement Wellbeing 5, 8 (Oct. 2006), *available at* http://www.dartmouth.edu/~alusardi/Papers/FinancialLiteracy.pdf (same).

[214] James M. Lacko & Janis K. Pappalardo, Fed'l Trade Comm'n, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms 81 (2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf. *Cf.* Susan Woodward, Consumer Confusion in the Mortgage Market 2 (2003), http://www.sandhillecon.com/pdf/consumer_confusion.pdf (consumers who try to combine two or more price components in home mortgage shopping pay more for their mortgages than consumers who are shopping on a single price component).

[215] *Id.*

steps in shopping for a loan.[216] Even a disclosure that a broker is not the borrower's agent does not overcome this deep assumption by borrowers that the loan originator is, in fact, acting as the borrower's agent. [217]

The combination of seemingly unshakeable trust and the inherent complexity of the transaction make disclosure an inadequate method of addressing loan originator compensation. Loan originator compensation must be substantively regulated.

2. The Board Should Ban All Loan Originator Compensation Based on the Loan Amount

a. *Principal-Based Compensation Is Subject to the Same Abuses as Rate-Based Compensation*

We oppose loan originator compensation based on the principal amount. Loan originators have often encouraged borrowers to increase loan amounts in order to recover higher payments for the creditors. If loan originators can no longer increase their compensation by the size of the loan they sell, they will no longer be subject to the current temptation to push the refinancing of unsecured debt, the extra cash-out "just in case," and the packing of additional fees into the principal.

Increasing the debt strips equity; the damage caused by equity stripping cannot be recovered in a refinancing, unlike that caused by an inflated interest rate. Thus, in important ways, permitting compensation based on principal amount while banning compensation based on interest rate results in greater harm to homeowners. If the homeowner is overcharged in the interest rate, she can refinance once she realizes the problem. When the principal amount is inflated, the homeowner is stuck with the damage.

Even beyond the unsecured debt needlessly refinanced and the junk fees added, increased principal results in increased costs for a homeowner across the board: title insurance and fees, for example, are usually tied to loan amount, as well as the creditor's origination fees. The Board also notes that a higher loan amount could cost the borrower substantially in other ways: a higher loan amount may tip the borrower into a different loan-to-value category, with a resulting increase in the interest rate and mortgage insurance.[218]

There is no reason to think that borrowers would understand originator incentives based on the size of the loan amount any more than they understand originator incentives based on interest rate. The result would likely continue to be that most vulnerable

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[216] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages, at iii (2009).
[217] 73 Fed. Reg. 1672, 1698 (Jan. 9, 2008).
[218] 74 Fed. Reg. 43,232, 43,284 (Aug. 26, 2009).

consumers would end up with loans that are too large and too expensive.[219] The Board should not permit loan originator compensation based on the loan amount, whether paid by the creditor or the borrower.

b. *Even If the Consumer Pays the Broker Directly, Principal-Based Compensation of Loan Originators Should Not Be Allowed*

There is no reason to believe that having the consumer pay the broker compensation undoes the perverse incentives that arise if the broker gets more depending on the size of the loan. Consumers are not likely to stop relying on brokers as trusted advisors simply because they are told that the compensation will be based on a percentage of the principal.

Even in the current market, it is not uncommon to see loans split into two—one loan for what the borrower wanted and the second loan to pay the closing costs and loan originator. This problem will grow only more pronounced if the Board allows consumers to pay the broker directly, with the size of that payment increased the larger the principal is. The rule should be applicable to the broker fee, regardless of the source -- lender, equity or borrower's cash.

As the Center for Responsible Lending makes clear in their comments, there are numerous other ways for a broker to be compensated. Indeed, the most straightforward, an hourly-rate fee, would do much to encourage loan originators to find lenders for borrowers who want only to borrow what they need, at terms they can afford, since finding such loans may require more time and effort than finding large loans on onerous terms.

3. Loan Originator Compensation Should Come From a Single Source

a. *The Board Is Correct to Ban Third-Party Payments to Loan Originators When a Consumer Pays a Loan Originator, Either Directly or Through Equity*

The Board recognizes that the worst possible result for homeowners is when some compensation is paid by the lender and some is paid by the homeowner. As the Board notes, dual payments act to conceal the lender-paid compensation.[220] Worse, lender-paid broker compensation, as HUD has detailed, leads to higher settlement costs and higher broker costs, as well as higher interest rate costs.[221] When a loan originator is paid both

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[219] *Cf.* 74 Fed. Reg. 43,232, 43,280 (Aug. 26, 2009) (discussing the failure of the market to constrain broker incentives to sell consumers high-cost loans "especially as to consumers who are less sophisticated").
[220] 74 Fed. Reg. 43,232, 43,282 (Aug. 26, 2009).
[221] Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-24 to 2-43 (2008).

by the homeowner and the creditor, homeowners will pay the most—and not just for broker compensation, but for other closing costs as well.[222]

The Board should make clear in the Commentary that the transaction must be viewed as a whole. The Board's prohibition must ensure that lenders cannot find their way around the prohibition of single source transaction by splitting the transaction into two loans—one with an increased interest rate and another funding the broker's fees.

b. *The Board Should Clearly Forbid Mixed Rate and Fees Compensation*

In the proposed commentary, the Board suggests that lenders could charge an interest-rate premium dependent on how much of the transaction costs a borrower pays.[223] This is exactly the wrong approach. Only when all the fees are pushed into the interest rate do borrowers realize a cost savings.[224] The mixed rate and mixed fees approach will impede transparency and encourage loan originators and other third-party service providers to increase their fees. The Board must clearly forbid all instances of dual-source compensation.

4. The Restrictions on the Methods of Loan Originator Compensation Should Apply to the Entire Market, Including HELOCs

There is no reason to limit the proposed rules under Regulation Z § 226.36 to any segment of the market. Lender-paid broker payments led to distortions in prime market lending, as well as subprime. Moreover, recent history demonstrates that loan originator compensation can contribute to the proliferation of new and unforeseen—and dangerous—products. The only way to ensure rationality—and a level playing field for all creditors and originators—is with a uniform rule.

C. The Board Should Not Use Disclosure to Immunize Loan Originators From Steering

For the reasons the Board sets out in the Supplementary Information accompanying the proposed rule[225] as well as the Center for Responsible Lending's detailed comments, the Board must adopt an anti-steering rule. But the Board's rule falls far short of what is required. Instead of banning steering, the Board actually authorizes steering, so long as borrowers are provided with three possible loan options. These need not be loans the consumer is actually eligible for, nor need the borrower actually end up with any of the loans. All a broker need do is put the loans in front of the borrower, obtain a signature from the borrower indicating that the borrower was "permitted" to

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[222] Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-24 to 2-43 (2008).
[223] 74 Fed. Reg. 43,232, 43,408 (Aug. 26, 2009) (proposed comment § 226.36(d)(1)-5).
[224] Susan Woodward, A Study of Closing Costs on FHA Mortgages, U.S. Department of Housing and Urban Development, Office of Policy Development and Research. (2008), *available at* http://www.urban.org/UploadedPDF/411682_fha_mortgages.pdf.
[225] 74 Fed. Reg. 43,232, 43,280–43,285 (Aug. 26, 2009).

choose from among those loans, and then present the borrower with an entirely different loan of the broker's choosing.

Even as disclosure, the three-option proposal is seriously flawed. The Board puts few limitations on the form or manner of the disclosures. The Board does not provide how these loans should be disclosed. Since the loan originator will be allowing the borrower to "choose" among these three loans before application, there is no independent requirement that the borrower will receive either a Good Faith Estimate or a Truth-in-Lending disclosure. Either document could help a borrower choose among the loans; without either, the borrower is left guessing and at the mercy of the loan originator's discretion in presenting the material. Will the APR be presented? With or without the new graphic the Board is proposing for the TIL disclosure? Will borrowers be told the monthly payment on their loans? Will they be told if the loans have an escrow requirement or mortgage insurance? The Board is silent on all these questions and more. The loan originator must "present" the loans to the borrower, but what that means will apparently be left to individual loan originators to determine.

The Board does little to define the options presented, either. Some originators work with dozens of lenders, yet need only consult three in choosing which products to present. The Board requires three options for each "type" of loan presented, lumping all variable rate and all non-variable rate transactions together. Variable rate mortgages could include payment option ARMs and hybrid ARMs. Fixed-rate mortgages could include mortgages with balloon-payments or interest-only periods. The pricing on these products is not directly comparable.

As the Board has learned through its testing, people trust their loan originators.[226] The Board's three-loan option might act as a reasonable break on that trust, provided the Board more narrowly circumscribes the options presented and the manner of their presentation. Disclosure of the three options should be tested to ensure that consumers can use them as the Board envisions. The Board must not create a safe harbor, but only a rebuttable presumption, given the possibility of oral representations that overshadow the written terms.

The Board's proposal at its base does little more than use disclosure to immunize loan originators from shady behavior. Under the Board's proposal, disclosure of at least three loan options would be deemed conclusive proof of no steering.[227] Given all we have learned in recent years about the dangers of steering for borrowers, creditors, and the national economy.

[226] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages, at iii (2009).
[227] 74 Fed. Reg. 43,232, 43,409 (proposed comment § 226.36(e)(3(2)-1) (Aug. 26, 2009).

XII. CLOSED-END DISCLOSURES—§§ 226.37 and 226.38, 226.27[228]

A. *Introduction: The Board's Overall Approach to Closed-End Disclosures Is a Significant Improvement, But Needs Certain Corrections*

We support the Board's proposed extensive improvements in the required closed-end disclosures—especially in the mortgage disclosures. The proposal should, with some exceptions discussed below, give consumers a significantly better opportunity to understand what creditors offer them. The new disclosures will better focus consumers' attention on the APR, the maximum payment, and the ultimate question of whether loan offers are appropriately priced in light of the applicant's creditworthiness. Printing the APR in a minimum 16-point font should be especially helpful in attracting consumer's attention to the APR disclosure.[229] The proposed APR graph is one of the best additions to the mortgage disclosures.

We also compliment the Board for drafting Proposed Regulation Z § 226.38 to apply to all transactions secured by real property, even if the property is not a dwelling, and even if the transaction is not subject to RESPA. Real estate loans for personal purposes, even those for vacant land and construction loans, should be covered. For many consumers, a mortgage loan will be the most complex and expensive transaction in their lives. The disclosures required by Regulation Z are vital for protecting the typical consumer who would otherwise lack the financial knowledge needed to make an informed choice. A more uniform rule that applies the disclosure requirements to all transactions secured by real property will promote more streamlined procedures for creditors and will result in lower costs to all parties affected. Expanding the coverage will simplify compliance and increase comparability of pricing throughout the mortgage market.

Nevertheless, while the proposal contains many improvements, a number of details should be refined, corrected, or eliminated to make the proposal acceptable. As further explained in this section of our comments, we recommend that the Board:

- Design the disclosure to more actively encourage consumers to comparison shop and negotiate.
- Translated disclosures should be required where advertising or negotiation is not in English.
- Require creditors to use: the model forms as designed, to use a minimum 12-point font for the most important disclosures, and to ensure that color and type style do not interfere with legibility.
- Require that disclosures should disregard offered incentives to consumers that could distort disclosures.
- Fix flaws in the proposed loan type and loan features disclosures.

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[228] The disclosure regime for HELOCs is discussed at Sections III and IV of those comments.

[229] This requirement could, however, be improved by making the font size relative to the surrounding text, rather than setting an absolute size, to ensure the APR remains more conspicuous even when a creditor uses a large font for the surrounding text.

- Correct an error in the annual percentage rate disclosure section.
- Improve other aspects of the annual percentage rate disclosure section to facilitate enforcement and avoid confusion.
- Revise all negative amortization and payment option disclosures *or banish these terms from loans secured by the borrower's principal residence.*
- Require creditors to provide an itemization of the amount financed or a HUD-1 settlement statement at least 3 days before the closing; eliminate the "provide nothing" option.
- Make the "no escrow account" notice more effective.

One other important matter involves the transactions to which the closed-end disclosures apply. We encourage the Board to ask Congress to end the antiquated Truth in Lending exemption for certain transactions with an amount financed over $25,000.[230] This exemption detracts from the effectiveness of the Board's revised closed end disclosures, since the disclosures now do not apply to many motor vehicle and other non-mortgage loans.[231]

B. *The Disclosures Should More Actively Encourage Shopping and Negotiation*

We commend the Board's decision to conduct testing on a new Mortgage Shopping Checklist, in that the Board recognized the help consumers need to shop more wisely. But we are disappointed the Board so easily abandoned the idea of giving the checklist to all potential borrowers.[232] We encourage the Board to do further testing on variations of the checklist and other shopping guides. One of the primary goals of the Truth in Lending Act is to enable consumers to comparison shop. 15 U.S.C. § 1601(a). The Board clearly recognizes this and has described how the proposed changes are expected to facilitate comparison shopping.[233] Yet, despite the recognized importance of this goal, the existing and proposed model forms say nothing that would encourage consumers to comparison shop or negotiate for better loan terms.

The Board should require creditors to provide each applicant with a well-designed and tested mortgage shopping guide or checklist. The guide should encourage consumers to shop based on the APR rather than the interest rate or monthly payment in addition to providing other relevant information and resources like those included on the Mortgage Shopping Checklist in Appendix D of testing report. The Board should also require creditors to include specific, consumer-tested language encouraging consumers to shop and negotiate. This language should appear with the disclosures described in Regulation Z §§ 226.17, 226.18,[234] 226.37, and 226.38. Consumers should be informed in clear,

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[230] 15 U.S.C. § 1603(3).
[231] If the original $25,000 amount had been adjusted for inflation, it would now only exclude loans with an amount financed in excess of $145,000. Clearly, the present exemption does not square with the original Congressional intent.
[232] *See ICF Macro* at 83–84, Appendix D.
[233] *See, e.g.*, 74 Fed. Reg. at 43,297 (discussing Proposed Regulation Z § 226.38(b) and APR graph).
[234] We note, as an aside, that Regulation Z §§ 226.17 and 226.18 have the same title, "General disclosure requirements." We encourage the Board to rename one of them to avoid confusion.

simple, prominent statements that they are allowed to ask for a better rate than what they have been offered; they are allowed to ask for a fixed-rate loan instead of an ARM; and that they are allowed to take their copy of the TIL disclosures to another lender and say "can you beat this?" Encouraging consumers to do so is not only in their own best interest but will also promote a more competitive and honest market.

The Board's consumer testing shows most consumers do not shop for mortgages. Those who do often stop "once they had applied for a particular loan and received a TILA disclosure."[235] Participants reported that, at best, they rely on originators' oral quotes regarding rates and fees.[236] These findings and others led the Board to conclude "consumers need information early in the process and that information should not be limited to information about ARMs."[237] This is the right conclusion, but the Board has not yet acted upon it.

While the Board expresses great optimism that consumers will use the proposed disclosures to shop and negotiate,[238] the consumer testing results suggest consumers will not do so without specific reminders and encouragement. The most appropriate way to encourage consumers to use the disclosures as a shopping tool is to tell them to do so. In addition to requiring creditors to give consumers a shopping checklist or guide with the application, the Board should add a shopping notice to the grouped and segregated disclosure forms. Suggested notices are:

- You have the right to ask your lender for a better rate.
- You have the right to shop elsewhere and to show this form to other lenders.
- Show other lenders this form and ask if they can do better.
- It's not too late to shop elsewhere.
- It's not to late to shop for a better loan.
- Negotiate! Comparison Shop! It can save you money.

Creditors will inevitably oppose this suggestion but only because they fear competition. Given the consumer protection goals of TILA and Regulation Z, that is not an appropriate basis for rejecting this proposal. If creditors were given a choice, they would not make any of the required disclosures. Adding a statement encouraging consumers to comparison shop will promote honest competition in the marketplace. The limited testing done on the Mortgage Shopping Checklist shows that consumers may be receptive to shopping recommendations and advice. The Board should conduct further testing on these ideas and reconsider requiring creditors to include these notices with applications and the grouped and segregated disclosures.

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[235] 74 Fed. Reg. at 43,235
[236] *Id.*
[237] *Id.*
[238] *See, e.g.*, 74 Fed. Reg. at 43,297, 43,298 ("Showing potential savings that could result from a lower APR would help encourage consumers to shop and negotiate for better loan terms . . . .")

C. *Translated Disclosures Should Be Required Where Advertising or Negotiation Is Not In English*

Brokers and creditors have often engaged in egregious bait-and-switch tactics with homeowners whose primary language was not English with the assurance that the borrower could not discover the deception until well after closing. The Board should use its rule-making authority to amend Regulation Z § 226.27 to require translated disclosures where the creditor advertises in a language other than English or where the loan originator negotiates the credit transaction primarily in a language other than English. The fiction of informed choice collapses entirely when disclosures are provided in a language that the homeowner does not understand. As one court confronting this problem observed, "'[D]isclosing' the true terms of a document written in a foreign language is tantamount to no disclosure at all." Martinez v. Freedom Mortgage Team, Inc., 527 F. Supp. 2d 827 (N.D. Ill. 2007).

D. *The Board's Proposal Will Improve the Readability and Usability of Disclosures, but More Format Improvements Are Necessary*

1. Be More Prescriptive; Require Creditors to Use Model Forms and Identical Terminology

We urge the Board to be more prescriptive about the terminology, headings, labels, and descriptions that creditors must use in their disclosures. According to the proposed rules, many of the disclosures need only be "substantially similar" to the model forms in headings, content, and format. *See, e.g.,* Proposed Regulation Z §§ 226.19(b)(4)(iv), 226.38(a)(6). Proposed Regulation Z § 226.37(c)(1) only requires creditors to use "consistent"—but not identical—terminology when making the disclosures required by §§ 226.19(c),[239] 226.20(c)[240] and (d),[241] and 226.38.[242]

These requirements leave some problematic ambiguities. The phrase "substantially similar" does not appear to be defined anywhere in the proposed regulations or proposed commentary. Notably, it is not clear whether requiring the disclosure "content" to be substantially similar to the model forms means the *language* used or the subject matter covered must be substantially similar.

By mandating: "Terminology used in providing the [required] disclosures . . . shall be consistent[,]" Proposed Regulation Z § 226.37(c)(1) begs the question "consistent with what?" One likely answer is that disclosures issued by a single creditor must be internally consistent—within a single document—and consistent with all other documents provided in regard to a single loan or consumer. Another possibility is the terminology must be consistent with the terminology used in the regulations. Both

[239] Early disclosures and ARM disclosures.
[240] Rate adjustment notices.
[241] Periodic statements for loans with payment options.
[242] Disclosures for closed-end mortgages.

possibilities are important and are mutually compatible. We recommend that the Board explicitly state these requirements in the rule.

Disclosure terminology must also be consistent among different creditors. Permitting the use of inconsistent terminology would thwart the Board and Congress's desire to facilitate comparison shopping. This rule, however, is insufficient to require consistency among different creditors because creditors cannot be expected to anticipate what their competitors will say. The Board can only issue an effective mandate for consistency among different creditors by specifying mandatory terminology in the rules, commentary and model forms.

Instead, the commentary confuses matters by saying "[l]anguage used in [the specified disclosures] must be close enough in meaning to enable the consumer to relate the different disclosures; however, the language need not be identical, unless the use of specific terminology is required." Proposed Official Staff Commentary § 226.37(c)-1. The commentary should, instead, require the use of identical terminology wherever possible throughout all of the creditor's documents. Otherwise, a creditor could use different terminology within the same document or change terminology between disclosures. Without a requirement to use the same terminology as specified in the regulations, different creditors are more likely to use inconsistent terminology that will make it more difficult for consumers to compare loan offers.

As indicated by ICF Macro in its closed-end consumer testing report, it is important to provide information using language that facilitates the comparison of terms between disclosures.[243] This applies to disclosures from different creditors as well as the initial and final disclosures from a single creditor. If the language used is different—even if close in meaning—consumers may have trouble identifying the equivalent information when comparing documents.

> In a disclosure regime like that currently in place for mortgages, consumers get information about the product for which they are applying at multiple points in time. One goal of these disclosures is to help consumers track the terms of their loan at each stage in the process to make sure nothing changes without their knowledge. To facilitate this, the . . . language that is used to describe various aspects of the product, should be made consistent between disclosures whenever possible.[244]

Labels and descriptions that have a consistent meaning but which are expressed in different words will be more difficult for consumers to compare. Consumers may understand the words used for one label or description, but not understand the words used in another. The assumption that consumers will understand words that are different but "close enough in meaning" (i.e., synonymous) assumes a level of education and financial

[243] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 23 (July 16, 2009).
[244] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 23 (July 16, 2009).

sophistication that some consumers, especially first-time borrowers, may lack. The use of different words also reduces a consumer's ability to quickly scan a document for the information needed. If identical terminology is used throughout the creditor's documents and by all creditors, a consumer who does not understand the terminology in a specific label may still be able to use the label as a symbol for something he knows is important—but only if the creditor uses the same words each time the label appears.

For example, the terminology "ARM," "Adjustable Rate Mortgage," and "Variable Rate Note" are all consistent but, as proven with consumer testing, it is unfair to assume every consumer will recognize that all three terms have the same meaning.[245] ICF Macro reported some participants were more familiar with the term "adjustable rate" and others did not realize that "variable rate" meant the same thing.[246] As a result, ICF decided to use the *same* phrase ("adjustable rate") on all revised disclosure forms.[247] This demonstrates that "consistent" terminology is not good enough. The Board should use the consumer testing results to select the best terminology and then require creditors to use "identical" terminology in the disclosures, especially for high-risk, counter-intuitive loan features such as negative amortization. If the Board crafts language through consumer testing, creditors should be required to use it without variation.

2. Require a Minimum 12-Point Font Size for the Most Important Disclosures[248]

Currently Regulation Z does not impose any minimum font size for closed-end credit disclosures. The proposed regulations add a 10-point minimum, but only for mortgage disclosures.[249] Proposed Official Staff Commentary § 226.37(a)-1. This is a welcome start, but 10-point text is still too small, and the failure to impose a minimum for non-mortgage disclosures is a notable omission.[250] The cliché regarding important details being hidden "in the fine print" does not exist without reason. The Board should impose a 12-point minimum for all important disclosures, in addition to the proposed 16-point minimum for the APR.

The Board specifically rejected previous calls for adopting a 12-point minimum by noting that testing shows consumers can "read and notice information in a 10-point font."[251] The appropriate question, however, is not merely whether consumers can read and notice information. Many consumers can—if given sufficient time and light—probably read and notice information in much smaller fonts as well. The question should be whether a 12-point font minimum would increase consumers' ability to read and

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[245] ICF Macro, Summary of Findings: Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 12 (July 16, 2009).
[246] *Id*. at 17.
[247] *Id*.
[248] This section is printed using a 10-point font. The rest of our comments are in 12-point font.
[249] The proposed commentary says: "disclosures required for transactions secured by real property or a dwelling, and therefore, also subject to § 226.37, must be segregated from all other material and be provided in a minimum 10-point font." Nevertheless, the proposed changes to Appendix H indicate that some of the table headings on the model forms are printed in 9-point font. Appx. H-18(iii)(C). Elsewhere, the proposed regulations require the APR to be disclosed in at least a 16-point font. Proposed Regulation Z § 226.37(c)(2). We congratulate the Board for imposing a higher minimum on the APR disclosure.
[250] Proposed Official Staff Commentary § 226.37(a)-1 also says "disclosures for transactions subject only to § 226.17(a)(1) . . . not be given in a particular type size."
[251] 74 Fed. Reg. 43,428, 43,441 (Aug. 26, 2009) (HELOC proposed rule).

identify important information. To the best of our knowledge, the Board has not conducted any consumer testing on this question.

Testing has already shown that font size has an impact on the effectiveness of disclosures.[252] Consumers will be more likely to read and identify information if disclosures are made in a larger font. Regulation Z should impose a 12-point minimum font for all of the mandatory mortgage and non-mortgage disclosures. We have tested some of the proposed model forms using a 12-point font and found that the forms can still be used as designed, on a single page, with the larger font.

The Commentary to Regulation Z § 226.17(a)(1) notes that "the disclosures must be legible," but legibility is subjective and often dependent on text size. Official Staff Commentary § 226.17(a)(1)-1. The FRB itself notes that "Consumer testing . . . showed that . . . the use of small print led many participants to miss or disregard key information about the loan transaction."[253] The National Eye Institute at the National Institutes of Health reports that 66% of adults wear some type of eyewear, including glasses, contact lenses, both glasses and contact lenses, or reading glasses only. Among older adults, 94% report wearing eyewear.[254] Imposing a minimum 12-point font size for all disclosures would set a simple bright-line rule that would make compliance easier than the current, vague legibility standard used for non-mortgage disclosures. It would make all disclosures easier to read.

A 12-point minimum would also address an issue created by widespread use of the Adobe PDF format among computer users. Many creditors and settlement agents transfer disclosure statements by e-mail documents in Adobe PDF format.[255] Consumers receiving electronic disclosures are also likely to receive them in this format. The Adobe Reader software, a free, commonly used program for reading and printing PDF documents[256] has a printing feature called "Page Scaling" which allows the user to control the size of the electronic document as it appears on the printed page. The default Page Scaling setting is "Shrink to Printable Area," which reduces the size of the original document so it can be printed without risk of the edges being cut off by the printer (to 96% of the original size for one printer we tested, 94% for another). This means any disclosure statement written in a 10-point font may ultimately be printed in a manner that results in the consumer receiving a 9-point or smaller font. Imposing a 12-point minimum would mitigate this problem.

3. Ensure That Color and Type Style Does Not Interfere with Legibility

Proposed Official Staff Commentary § 226.37(a)(2)-1 says creditors may meet the requirement to segregate certain disclosures by printing them with "a different color background" or in "a different type style." The Board should add commentary specifying that any colors used in disclosures should be accessible by consumers with color blindness.

The commentary should also discourage the excessive use of words printed in all capital letters. While printing words in all capital letters can make individual words or short phrases more prominent, printing large blocks of text in this style makes the text more difficult to read. Researchers, typographers, and legal editors discourage the

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[252] Macro International, Inc., Design and Testing of Effective Truth in Lending Disclosures iii, 7, 12, 15, 20 (May 16, 2007).
[253] 74 Fed. Reg. at 43,287.
[254] Fact Sheet: Refractive Errors, Nat'l Eye Institute, National Institutes of Health, *available at* http://www.healthyvision2010.nei.nih.gov/hvm/pdfs/HVM09_Fact_Sheet_Final_tagged.pdf.
[255] The FRB also uses PDF files on its own web site. *See* http://www.federalreserve.gov/faqs.htm (FAQ entitled "Why are some files in PDF format, and how can I read them?").
[256] The manufacturer of Adobe estimates "about half a billion people are running Adobe Reader." E-mail from Rick Borstein, Business Development Manager, Adobe Systems Inc. (Nov. 23, 2009).

excessive use of text set in all capital letters because it can negatively impact comprehension and slow reading speed. Segregating disclosures by printing them in all-caps text can have the perverse consequence of discouraging consumers from reading important information.[257]

E. *Disclosures Should Not Be Based on Creditor Incentives Offered to Consumers*

Proposed Official Staff Commentary § 226.17(c)(1)-1 (and existing Official Staff Commentary § 226.17(c)(2)(i)-3) requires disclosures to be based on the assumption that consumers will abide by the terms of the contract, including making complete and timely payment. We support this requirement, but recommend additional commentary to prevent creditors from twisting this assumption in a manner that would prevent consumers from receiving truly accurate disclosures.

For example, if a creditor offered consumers an interest-rate discount for paying on time, the creditor would be required to base the disclosures on the assumption that every consumer would receive the discount.[258] The same problem could apply if creditors offer a rate discount to induce consumers to sign up at application for automatic payments via payroll or bank account deductions (as contemplated in Proposed Regulation Z § 226.19(a)(2)(iv)(A)).[259] Either of these examples would allow the creditor

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[257] One small study using U.S. Navy e-mail messages written in all-caps reported that participants "specifically disliked and found it difficult to locate important information using the all capital-letters format." Sarah Greer et al., Email Format and Instructions: *Influences on Reading Times, Retention, and Preferences*, 1 Am. J. of Psychological Research 126 (2005). The study also observed that when participants knew they would not be questioned on the content read, "they spent the least amount of time reading emails in the all-capital-letter format, most likely because they did not like reading that format." *Id*. at 128. Another article reported: "Upper case type is read about 13 percent slower than lowercase type." *Id.* at 119 (citing M. Tinker, *Prolonged Reading Tasks in Visual Research*, 39 J. of Applied Psychology, 444–446 (1955)). "Most words contain some letters with ascenders/descenders, and this . . . creates rhythmic contrast in the exterior shapes of words written in lower or mixed case. Words written entirely in uppercase letters do not share this contrast . . . . Large amounts of text set in all caps are more difficult to read as a result of this lack of contrast." Paul Kahn and Krzysztof Lenk, *Design: Principles of Typography for User Interface Design*, Interactions Magazine 18 (Nov/Dec. 1998). *See generally* Bryan Garner, Legal Writing in Plain English § 44 (discouraging use of all capitals).

[258] The mortgage lender HFC (d/b/a Beneficial Homeowner Service Corp.) offered such an incentive with its "Pay Right Rewards Program" in 2005. The program offered to lower a borrower's interest rate up to 3% as an incentive for timely payments. A borrower would lose the rate discount for one late payment. In one example, the contract rate on the loan was 9.29%, but the incentive program enabled HFC to issue TIL disclosures showing a 7.07% APR and a payment schedule with decreasing monthly payments. A copy is attached as Appendix V, *infra,* Loan Agreement, Beneficial Homeowner Service. We thank Rebecca Case-Grammatico, Esq. of the Empire Justice Center for providing this sample.

[259] Proposed Regulation Z § 226.19(a)(2)(iv)(A) refers to "[a] decrease in the loan's [APR] due to a discount the creditor gives the consumer to induce periodic payments by automated debit from a consumer's deposit or other account." If the rules and commentary are modified to require creditors to disregard incentives when making disclosures, Proposed Regulation Z § 226.19(a)(2)(iv)(A) would be moot.

to cancel the discount and raise the interest rate for any consumer who paid late or whose payroll deduction was cancelled.[260] This would, in effect, be a hidden penalty rate.

The existing commentary in Official Staff Commentary § 226.17(c)(1)-2 does not fully address the problem of incentives that can distort mandatory disclosures. Official Staff Commentary § 226.17.(c)(1)-2 provides that an informal modification of the legal obligation should not be reflected in the disclosures "unless it rises to the level of a change in the terms of the legal obligation." Incentives, however, can distort the disclosures precisely because they rise to the level of a change in the obligation. Although paragraph 2(ii) of the Commentary says a voluntary payroll deduction should not be reflected in the payment schedule disclosure, this example would not apply to the situation where a consumer agrees to payroll deductions in return for the creditor's binding promise to provide an incentive. The current and proposed rule and commentary would require the creditor in such a situation to make disclosures that reflect the incentive as long as the consumer signs up for it before the disclosures are issued.

Incentives for timely payment are more insidious because the consumer need not make any extra promise to earn the incentive. All contracts require timely payment and, because the rule requires creditors to assume borrowers will make timely payments, the rule would require disclosures to reflect the incentive even though the consumer would lose it upon making a late payment. This is especially perverse in subprime lending because subprime lenders expect consumers to occasionally pay late.

To prevent incentives from concealing penalties and distorting disclosures, paragraph 2 of the commentary should specify that creditors must disregard the effect of incentives when making disclosures unless the incentive cannot be withdrawn once initially earned. The term "incentive" should be broadly defined to include rate discounts, payment discounts, or anything else that would affect the loan disclosures. This change will not prevent creditors from offering the incentives, but will eliminate their deceptive effect on the disclosures.

F. *Loan Summary Section Is a Useful Improvement but the Loan Type and Feature Disclosures Are Dangerously Flawed*

1. Overview

The loan summary section for closed-end mortgage disclosures, described in Proposed Regulation Z § 226.38(a), is a welcome addition to the disclosure statement. By summarizing the basic terms of a loan at the top, this new requirement should help consumers quickly determine whether they are willing to further consider the loan offered and whether the creditor has changed the loan initially disclosed. Adding the loan amount and the loan term will also simplify the process of locating these vital details.

[260] Creditors can terminate automatic payment arrangements if the consumer's account has insufficient funds. Consumers can usually terminate such payments voluntarily and may need to do so upon changing banks or employers. Any of these events would result in loss of the rate discount.

Nevertheless, while useful, the summary requires revision. The proposed definition of the adjustable-rate mortgage type[261] is flawed and should be improved. More importantly, disclosures of the negative amortization and payment option features[262] contain glaring defects that seriously impair the Loan Type and Features disclosure.

2. Reform or Eliminate the Negative Amortization and Payment Option Features

a. *Introduction*

Proposed Regulation Z § 226.38(a)(3) mandates disclosure of the loan type and features. The four features defined in the rule are: interest-only payments, payment option, negative amortization, and step-payments. Regulation Z § 226.38(a)(3)(ii). A disclosure form may only include two of the four features.[263] Although we support the loan feature concept, the proposed payment option and negative amortization features are poorly designed and would obscure the true nature of these features. As previously described in section XII(F)(2), we believe negative amortization should be banned because it poses an unreasonably high risk to consumers and because no disclosure form could adequately explain it. As explained below, the regulations addressing these features should be substantially modified—or these features should be banned.

b. *Definition of Negative Amortization Feature Is Far Too Narrow*

The negative amortization feature is defined far too narrowly. According to Proposed Regulation Z § 226.38(a)(3)(ii)(C), a loan has a negative amortization feature: "If, under the terms of the legal obligation, the regular periodic payments *will* cause the loan balance to increase and the loan is not a loan described in paragraphs (a)(3)(ii)(B) [payment option feature] or (a)(3)(ii)(D) [interest-only payment feature] of this section" (emphasis added). As further explained in the proposed commentary, the "negative amortization" feature "*require[s]* the consumer to make payments that result in negative amortization—that is, the legal obligation *does not permit* the consumer to make payments that would cover all interest accrued or all interest accrued and principal." Official Staff Commentary §226.38(a)(3)(ii)(B) and (C)-1(i)(B) (emphasis added). In contrast, a loan has a payment option feature "If, under the terms of the legal obligation,

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[261] Proposed Regulation Z § 226.38(a)(3)(i)(A).

[262] Proposed Regulation Z § 226.38(a)(3)(ii)(B) and (C).

[263] As an aside, assuming for this footnote only that no other changes are made, we recommend clarifying Proposed Official Staff Commentary § 226.38(a)(3)(ii). The commentary's description of which features can be combined is difficult to read. The proposed commentary says the payment option and negative amortization features cannot be combined. Official Staff Commentary § 226.38(a)(3)(ii)(B) and (C)(ii)-1. The interest-only feature cannot be combined with either the payment option or negative amortization feature. Official Staff Commentary § 226.38(a)(3)(ii)(D)-1. The interest-only feature may, however, be combined with the step-payment feature. Official Staff Commentary §226.38(a)(3)(ii)(D)-1. These portions of the commentary should be revised and summarized to say: "The following three loan feature combinations may appear on a disclosure statement: interest-only/step-payment, payment option/step-payment, and negative amortization/step-payment. No other combinations are permitted on the disclosure statement."

the consumer *may* choose to make one or more regular periodic payments that may cause the loan balance to increase, " Proposed Regulation Z § 226.38(a)(3)(ii)(B) (emphasis added).[264]

As defined by the regulation and commentary, loans with a negative amortization feature must, in effect, forbid the consumer from making interest-only or fully-amortizing payments. This would also be the equivalent of an outright prohibition on any partial prepayment, no matter how small. Such loans are very rare. This means the negative amortization feature, as defined, will almost never appear on a TIL disclosure. Given the havoc negative amortization has wrought upon homeowners, the Board must revise the proposed definition of the negative amortization feature to apply to any loan terms under which negative amortization is possible.

c. ***Payment Option Disclosure Conceals Presence of Negative Amortization***

As currently written, Proposed Regulation Z § 226.38(a)(3) favors disclosure of payment options over disclosure of the more important negative amortization feature. Because the payment option and negative amortization features are defined as being mutually exclusive, the proposed commentary prohibits using both terms for the same loan. Official Staff Commentary § 226.38(a)(3)(ii)(B) and (C)-1. This not only permits but *requires* a disclosure that emphasizes the "payment option" feature without mentioning the risk of negative amortization.[265] Rather than alerting consumers to the fact that one or more of the payment options will cause negative amortization, this mandatory disclosure conceals that fact from the consumer.

This is best illustrated by applying the proposed rules to a payment option ARM (POARM) in which one of the options is a monthly payment that will result in negative amortization. POARMs, the most common type of loan to permit negative amortization in recent years, would initially appear to have two features: a payment option and the possibility of negative amortization. Instead, under the proposed definition of these features, a POARM only has one feature—a payment option. Furthermore, the proposal would *prohibit* a POARM creditor from mentioning the possibility of negative amortization in the Loan Summary section of the disclosure form. Proposed Model Form H-19(I) shows how this disclosure could look:

Adjustable Rate Mortgage: rate is fixed for the first month, then adjusts every month.

- includes Payment Options[266]

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[264] The Commentary describes the "payment option" feature as a loan where "the terms of the legal obligation do not prevent the consumer from making payments that will decrease the loan balance." Official Staff Commentary § 226.38(a)(3)(ii)(B) and (C)-1(i)(B)-2.

[265] The "Key Questions About Risk" disclosure, discussed in Section VII(E)(6), is insufficient to cure this problem because the Key Questions are on a separate page.

[266] Regulation Z § 226.36(a)(3)(ii)(B) specifically says "the creditor shall disclose that the loan has a 'payment option' feature, using that term" (emphasis added to "a"). In doing so, the proposed rule refers to "a payment option feature" in the singular and specifically requires creditors to use the term "payment option[.]" Nevertheless, the proposed, sample model form refers to "payment options" in the plural. This means the Proposed Model Form H-19(I) does not comply with the proposed regulation.

This sample shows how truly inadequate the proposed rule is. According to the Supplementary Information published with the proposed rules, the loan summary section is designed, in part, to "help consumers determine whether they can afford the loan they are offered."[267] The loan-feature component is intended "[t]o alert consumers to potentially risky loan features[.]" The Board has recognized the need to "clearly alert consumers" to features including negative amortization before signing the loan.[268] Permitting or requiring a disclosure like this model, however, is contrary to the purpose of the rules. The mandatory term "payment option" does not alert consumers that one of the options will produce negative amortization and it says nothing of the potential risk.

Instead the term "payment option" and the sample disclosure in H-19(I) sound more like an industry-designed advertisement for a customer-friendly product than a consumer advisory from a federal watchdog:

Congratulations! We're giving you an adjustable-rate mortgage *with Payment Options!!*

As indicated by the Board's consumer research, consumers do not understand negative amortization[269] and, therefore, are even less likely to recognize the meaning of a "payment option" feature as defined in the rule. The proposed payment-option disclosure is confusing, contrary to the purpose of the proposed rules, and conceals far more important information. The payment option feature should be deleted from the proposal.

d. *The Loan Feature Rules Should Be Changed to Achieve Their Purpose*

While the Board is correct to require creditors to disclose the existence of a negative amortization feature (assuming this feature is not banned), the rule must be redesigned to be effective. The proposed loan-feature rule should be modified by deleting the payment-option feature and expanding the definition of negative amortization as previously described. The Board should also require creditors to concisely explain negative amortization, its risks, and its consequences using terminology comprehensible to the typical, unsophisticated consumer and using loan specific details—preferably in no more than one line of text.

Anyone attempting to meet this requirement will quickly discover that it is not only a tall order, but a Sisyphean task. We have not included a substitute for the Board's proposed disclosure because no disclosure could be adequate. The concept of negative amortization is complex by itself and even more so when coupled with payment recasting

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[267] 74 Fed. Reg. at 43,292.
[268] 74 Fed. Reg. at 43,293 (noting risk of payment shock from products with negative amortization).
[269] *See* ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 56, 70 (July 16, 2009) (indicating "few participants had previously heard the phrase 'negative amortization' ").

I. *Itemization of Amount Financed*

1. Overview

The proposed regulations include the existing option for mortgage creditors to substitute RESPA's GFE and HUD-1 for TILA's itemization of the amount finance. We support continuing to allow this alternative, but *only* if the Board adopts the all-in finance charge as discussed in Section IV and creditors are required to provide the HUD-1 at least 3 days in advance of the closing, as discussed in § VI, *supra.*[293] Closing costs can be significant so it is important to give borrowers information about them in advance of the closing date while there is still time to correct errors and make changes. As long as the closing costs have been incorporated into the APR, the HUD-1 will provide sufficient detail to meet borrower needs. If the Board weakens or does not adopt the all-in finance charge, the Board should require creditors to automatically provide an itemization for all transactions and should eliminate the alternatives.

Proposed Regulation Z § 226.38(j)(1) is generally the same as the current Regulation Z § 226.18(c). Both give closed-end mortgage creditors three options: provide an itemization of the amount financed, a statement that the consumer may request an itemization, or comply with RESPA's rules for providing a good faith estimate and settlement statement (Form HUD-1 or HUD-1A).

2. If Board Adopts All-In Finance Charge, Clarify Language of RESPA Alternative

The current and proposed rules both contain some ambiguity regarding which RESPA disclosures may be substituted for the itemization requirement. While the Commentary clarifies this ambiguity, it would be better to eliminate it. This can easily be accomplished without changing the meaning of the rule. Currently Regulation Z § 226.18(c) requires creditors to provide a "separate written itemization of the amount financed," but adds in a footnote: "Good faith estimates of settlement costs provided for transactions subject to [RESPA] may be substituted . . . ."[294] In doing so, it appears to say the only approved substitute is the good faith estimate—not the final HUD-1. Proposed Regulation Z § 226.38(j)(1)(iii) permits substitution of "A good faith estimate of settlement costs provided under [RESPA] . . . *or* the HUD-1 settlement statement provided under RESPA . . . ." (Emphasis added). The word "or" appears to create two options: provide a GFE *or* a HUD-1 in lieu of the itemization.

The current Official Staff Commentary § 228.18(c) clarifies that RESPA compliance is only a substitute for the itemization if creditors provide *both* the GFE and HUD-1. The Proposed Official Staff Commentary to Regulation Z § 226.38(j)(1), however, makes the issue more confusing because two passages of the Commentary are in conflict. The current Official Staff Commentary § 226.18(c) says "[t]ransactions

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[293] *See* Proposed Official Staff Commentary § 226.38(j)(1)-1 ("the HUD-1 settlement statement satisfies this [itemization] requirement only if it is provided to the consumer at the time required by § 226.19(a)(2)," i.e., "no later than three business days before consummation.").
[294] Regulation Z § 226.18(c)(1) n.40.

the absence of the proposed rule. Such a loan should be considered an ARM to alert the consumer that the amount of interest and monthly payments are not fixed.

To resolve these problems, we recommend changing Proposed Regulation Z § 226.38(a)(3)(i)(A) to say: "If the interest rate may change after consummation, the creditor shall disclose that the loan is an 'adjustable-rate mortgage,' using that term."[273]

G. *The Annual Percentage Rate Section Allows Focus on the APR but Has Notable Defects*

1. General

We support the Board's use of consumer testing to design new APR disclosures. The testing report contains many useful insights into what consumers understand when reading the disclosure forms. We believe the new disclosures will better focus consumers' attention on the APR and the ultimate question of whether the loan is appropriately priced in light of the applicant's creditworthiness. Printing the APR in a minimum 16-point font should be especially helpful in attracting consumer's attention to the APR disclosure.[274]

The testing report is also important because it illustrates the difficulties in overcoming public confusion surrounding the meaning and use of the APR as a loan evaluation tool. Too many consumers lack financial literacy—a problem that is compounded by industry marketing that encourages consumers to focus on the interest rate and monthly payment instead of the APR. We urge the Board to continue testing and research into the best way to design APR disclosures. In particular, we recommend the Board do further testing to: survey a larger number of people, including first time borrowers; learn more about how consumers use disclosures in the real world—beyond the controlled setting used in the Board's recent studies; and learn more about oral communications between consumers and originators regarding the cost of credit. It is well known that creditors use behavioral economics and consumer testing to develop profit making products. Therefore it is imperative that the Federal Reserve Board use the same tools to combat predatory lending and the uninformed use of credit.

Overall, the APR disclosure section, while an improvement, has some important defects. The average prime offer rate (APOR) and high cost zone disclosures are based on the wrong date. This error must be fixed to avoid confusing, anomalous results. The

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[273] As currently proposed, the rule says: "If the *annual percentage* rate may *increase* after consummation, the creditor shall disclose that the loan is an 'adjustable-rate mortgage,' using that term." (Emphasis added).

[274] This requirement could, however, be improved by changing it to specify that the APR should be printed in a font no less than 5 points larger than the font used for the rest of the disclosure statement (or average font size if more than one is used). Requiring the APR font size to be larger on a relative scale, rather than setting an absolute numerical requirement will ensure that the APR remains more conspicuous than the surrounding text even when a creditor voluntarily elects to print the surrounding text in a large font. Although unlikely, there is nothing to prevent a creditor from printing some of the other disclosures near the APR in 14- or 16-point text.

"how much could I save" disclosure, while a laudable concept, should be removed to avoid driving borrowers to loans with excessive points. The "how does this loan compare" disclosure is good but could be more clear. Finally, the disclosure statement omits the date on which the creditor sets the borrower's rate. As explained below, this should be added to the mandatory disclosures.

2. Proposed APR Graph Is a Significant Improvement

We strongly support the innovative graph in Proposed Regulation Z § 226.38(b)(2). The graph will offer consumers their best opportunity to compare the APR on a loan offer with important benchmarks. While borrowers are currently able to compare the APR on their loan with other advertised loan offers, it is more difficult to compare the APR with rates offered to prime borrowers because most data sources report rates as interest rates instead of annual percentage rates. Attempts to compare the interest rate on a loan with other interest rates will inevitably be unreliable for the same reasons that led Congress to enact TILA in the first place. The proposed regulations solve this problem by requiring creditors to disclose the APR in the context of the average prime offer rate and the higher-priced mortgage loan trigger. This finally gives consumers a clear and simple mechanism for determining whether the offered rate is appropriate in light of the consumer's credit history.

3. The Proposed APOR and High Cost Zone Comparison Rates Are Based on the Wrong Dates

The Board has expressed the "belie[f] that presenting consumers with information about other rates, current as of the week of the consumer's application, would help the consumers make more informed decisions about the loan offered."[275] We agree with the Board's belief and applaud the Board for any measure that promotes informed borrowing decisions. Unfortunately, due to an apparent drafting error, Proposed Regulation Z § 226.38(b)(2) and (3) require creditors to select the applicable rates from the wrong point in time. This error is serious but easy to correct.

The proposed APR section will compare the APR on the disclosed loan with the APOR and the HPML trigger in two ways: the graph described in Proposed Regulation Z § 226.38(b)(2), and the "how does this loan compare" statement in Proposed Regulation Z § 226.38(b)(3). Proposed subparagraph (b)(2) sets the location of the "high cost zone" on the proposed graph based on the HPML threshold. The HPML threshold is, in turn, calculated based on the APOR according to current Regulation Z § 226.35(a)(1).

More specifically, Proposed Regulation Z § 226.38(b)(2) requires closed-end mortgage creditors to include on the disclosure statement:

> [a] graph depicting the annual percentage rate . . . and how it relates to a range of rates including the average prime offer rate as defined in § 226.35(a)(2) *for the week in which the disclosure required under this*

[275] 74 Fed. Reg. at 43,297.

> *section is provided*, and the higher-priced mortgage loan threshold as defined in § 226.35(a)(1).

Proposed Regulation Z § 226.38(b)(3) similarly requires:

> [a] statement of the average prime offer rate as defined in § 226.35(a)(2), and the higher-priced mortgage loan threshold, as defined in § 226.35(a)(1), current *as of the week the disclosure is produced*.

In contrast, Regulation Z § 226.35(a)(1) defines a higher-priced mortgage loan as one that exceeds the HPML threshold "*as of the date the interest rate is set*" for the loan at issue. In short, the three quoted subparagraphs use three different dates:

- The date the interest rate is set;[276]
- The week the disclosure is provided;[277] and
- The week the disclosure is produced.[278]

This results in a confusing disclosure that mixes apples, oranges, and bananas. To resolve this problem, the Board should replace (b)(2) and (b)(3)'s references to the week of the disclosure with a reference to "the date the interest rate is set," as used in existing Regulation Z § 226.35(a)(1).

The reason this change is necessary becomes apparent when examining how the rule would be applied in practice. While creditors will initially set the interest rate on a loan no more than a few days before producing and providing the initial disclosure statement, the final disclosures might not be produced and provided until many weeks after the date the interest rate was first set. If the creditor does not change the rate during the intervening time, that means the APOR and the HPML could be very different by the time the final disclosure statement is provided. The passage of time and the different dates used in the rule could result in disclosures that inaccurately place a higher-priced mortgage loan below the high cost zone on the graph, or wrongly place a non-HPML in the high cost zone. If the final disclosures are produced and provided in different weeks, it is also possible that the graph would use different rates than the "how does this loan compare" disclosure below it. The following scenarios under Proposed Regulation § 226.38(b)(2) illustrate the problem:

[276] Regulation Z § 226.35(a)(1).
[277] Proposed Regulation Z § 226.38(b)(2).
[278] Proposed Regulation Z § 226.38(b)(3).

Scenario 1: Graph shows HPML below high cost zone
Assume the following facts:

- A borrower applies for a mortgage on March 1st;
- At that time, the higher-priced mortgage loan threshold is 8.0%;
- The lender sets the rate for the borrower's loan at 8.5% on March 1st;
- The borrower obtains a rate-lock at the same time;
- The closing is scheduled for April 3rd;

This creditor for this loan would be required to meet all the requirements for making higher-priced mortgage loans because the rate exceeds the HPML threshold "as of the date the interest rate [was] set" (i.e., on March 1st). The initial TIL disclosure would include a graph showing this loan in the high cost zone as of the week in which the disclosure is provided.

If the HPML threshold subsequently goes up to 9% before the creditor issues the final TIL disclosure, the loan would still be subject to the HPML regulations because the rate for the loan exceeded the HPML threshold as of the date the interest rate was set. When the consumer receives the final TIL disclosure, however, the graph would show the loan as below the high cost zone because the HPML threshold would be higher than the rate on the loan as of the week in which the disclosure would be provided. Consequently, the loan would be legally considered a HPML, however, the graph would wrongly show it below the high cost zone.

Scenario 2: Graph shows non-HPML in high cost zone
Assume all of the facts from Scenario 1 with the following changes:

- The lender sets and locks the rate on the borrower's loan at 7.5% (below the HPML threshold);
- The HPML threshold subsequently goes down, lowering the threshold to 7%.

In this scenario, the graph on the final disclosure form would show the non-HPML loan as being in the high cost zone because the zone would be defined based on the HPML threshold as of the week in which the disclosure is provided even though the loan would not be an HPML because, as of the date the rate on the loan was set, the HPML threshold was higher.

As these scenarios illustrate, the difference in language among the three subparagraphs discussed above can cause a significant problem with the APR disclosures, but this problem can easily be resolved by changing paragraphs (b)(2) and (b)(3) to match the language in Regulation Z § 226.35(a)(1). In the event that the Board does not make

the change recommended above, the terminology in subparagraphs (b)(2) and (b)(3) should at least be changed so the two subparagraphs match each other.

4. Disclosures Must Include the Date the Interest Rate Was Set

Regardless of whether the Board adopts the above changes, it is important that the Board add a new provision requiring creditors to identify the date on which the loan's rate was set. This information is necessary so regulators and consumer advocates can independently determine whether a loan meets the HPML trigger. If the date is not disclosed, anyone reviewing the disclosures for Regulation Z compliance will either need to guess or first obtain the creditor's records—something that may require a subpoena or which may be impossible if the creditor is no longer in business.

If the Board adopts the changes described in the previous section, the date on which the rate was set could be disclosed in the "how does this loan compare" disclosure[279] with a minor change to the model forms. The proposed model forms currently begin the "how does this loan compare" disclosure by stating: "For the week of *(date)*, the average APR . . . ." Proposed Model Form H-19(B). Under the existing proposal, the space for the date would be filled with the date the disclosure is produced. *See* Proposed Regulation Z § 226.38(b)(3). If the recommended changes are adopted, the date space should be filled with the date on which the rate was set.

If the Board does not adopt the recommended changes, the date could be disclosed in a sentence saying "the interest rate for the loan described in this disclosure statement was set on *(date)*" and printed outside the grouped and segregated disclosures. Regardless of where this disclosure appears, the Board should ensure that creditors will be subject to statutory damages if they omit the disclosure or make it inaccurately. Otherwise those seeking to enforce compliance with the requirements of Regulation Z § 226.35 will easily be thwarted.

5. The "How Much Could I Save" Disclosure Risks Unintended Consequences

Proposed Regulation Z § 226.38(b)(4) requires a statement of "[t]he average per-period savings from a 1 percentage point reduction in the APR . . . ." According to ICF Macro's consumer testing report, this information was added to counter the misconception "that a small difference in APR would not likely make a significant difference in the[] monthly payment."[280] While this disclosure is theoretically a good idea, it risks leading consumers to make misguided choices in a quest to lower their APR.

The most likely risk is that consumers will agree to pay points in return for a lower interest rate even when doing so would be against their best interests. Paying points for a lower rate only makes sense when the borrower will keep the loan long enough to recoup the cost of the points from the monthly savings. For example, a

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[279] *See* § XII.G.7, *infra*,discussing this disclosure in greater detail.

[280] ICF Macro, Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 56–57 (July 16, 2009).

consumer who borrowers $200,000 in a 30-year, fully-amortizing loan with a 7% fixed interest rate will have monthly payments of $1,330.60. If the same consumer pays $4,000 in cash for points that reduce the monthly payment to $1,280.62, the consumer will save $49.98 per month on the monthly payment but take over 80 months to pay for the points.[281] If the consumer finances the points—as many consumers probably will—the amount borrowed will consume another $4,000 of the consumer's equity and the borrower will take over 164 months to realize any savings. The same consumer may need even more time to realize any savings because the additional $4,000 added to the amount borrowed may trigger increases in other charges, such as transfer taxes, commissions, and other fees based on the loan amount.

The profits to be made from selling points will encourage brokers and bank employees to encourage consumers to purchase as many points as possible. While this may benefit borrowers who will keep the loan long enough to realize the savings, many others would ultimately save money by eschewing the points and paying a slightly higher interest rate. Although creditors can reduce the APR by lowering other finance charges, points are the most obvious and profitable method of doing so. The financial industry would almost certainly encourage consumers to pay points rather than voluntarily reducing other finance charges.

Additionally, the Board has recognized that the proposed savings statement will not be entirely accurate because "the proposed method does not result in an exact 1 percentage-point reduction in APR . . . ."[282] Any inaccuracy from the proposed method is compounded by the previously described variables that arise when a consumer finances the points. The only way the Board could make an accurate and reliable savings statement would be to require creditors to absorb all closing costs and non-interest finance charges as overhead and to compete solely based on the loan's interest rate. For now, there is not enough space on the disclosure form to properly explain whether points are worth the additional expense. The risk of keeping the savings statement without adding the necessary explanation outweighs any benefit to consumers. Therefore, the Board should delete Proposed Regulation Z § 226.38(b)(4).

6. Change "Average Best APR" Label to "Best APRs"

The proposed regulations call for the left end of the APR graph to be labeled "Average (or Avg.) Best APR." This label, however, is not as comprehensible as it could be. The phrase "Average Best" is a contradiction in terms and sounds awkward. Instead, we recommend using "Best APRs." The average prime offer rate is based on an average of rates offered on prime loans. Those rates are considered the best rates available. "Best APRs" is a more concise and comprehensible label than "Average Best APR."

7. "How Does This Loan Compare?" Disclosure Should Be Improved

[281] Assuming the points result in a new interest rate of 6.63%.
[282] 74 Fed. Reg. at 43,298.

The disclosure in Proposed Regulation Z § 226.38(b)(3) and the associated model form must be prescribed in greater detail to ensure it will achieve its intended purpose. According to the Board, proposed paragraph (b)(3) is intended to "help consumers navigate the information provided by the [rate] graph" and requires an explanation of the APOR and the HPML threshold.[283] The proposed model disclosure associated with this requirement appears as follows:

> **How does this loan compare?** For the week of (date), the average APR on similar [but] conforming loans offered to applicants with excellent credit was ___%. Today, an APR of ___% or above is considered high cost and is usually available to applicants with poor credit history.[284]

Unfortunately, the text of the proposed regulation falls far short of the description in the Board's statement of intent and the model form. Proposed paragraph (b)(3) merely requires "A statement of the average prime offer rate as defined in Regulation Z § 226.35(a)(2), and the higher-priced mortgage loan threshold, as defined in Regulation Z § 226.35(a)(1) . . . ." The regulation does not require an explanation of the APOR or HPML threshold, nor does it require anything close to the statement that appears in the model form. Because of the sparse language in the proposed regulation and the absence of any requirement that creditors use the same language appearing on the model form, creditors could render worthless the requirements of (b)(3) by simply interpreting it strictly. Instead of using the disclosure quoted above from the model form, paragraph (b)(3) appears to permit a far more limited disclosure, such as this:

> The average prime offer rate is 5%. The higher-priced mortgage loan threshold is 6.5%.

This is of absolutely no use to the typical consumer yet it probably would comply with paragraph (b)(3). Instead, the Board should be more prescriptive by requiring creditors to copy the model form and by changing the regulation to specify the exact language creditors must use in this disclosure. We also believe the sample on the model form is too wordy to be useful to consumers. Accordingly, we recommend adopting the following disclosure, including the black outline:

How does this loan compare?

As of [date]:[285]

- An average APR of 5% was offered to borrowers with <u>good or excellent credit</u> for conforming loans.
- An APR of 6.5% or higher was considered <u>high cost</u> and was usually offered to borrowers with <u>bad credit</u>.

It's not too late to shop elsewhere

[283] 74 Fed. Reg. at 43,298.
[284] Proposed Model Form H-19(B).
[285] *See* § XII.G.4, *supra*,discussing the date that should appear in this blank.

Our recommended substitute has several advantages. The language is simpler and clearer. The use of bullets and underlining improves clarity and readability, and will help consumers identify important information. The black outline separates this disclosure from the APR and graph above it, thereby reducing the chance that this disclosure will be ignored as "fine print" while preserving the emphasis on the other APR disclosures. The sentence "It's not too late to shop elsewhere" is a necessary improvement on the existing proposal because it fulfills TILA's goal of promoting comparison shopping. Although the supplemental information says the comparative rate disclosures are intended to help borrowers shop for the best rate, the proposed disclosure does not say anything to remind consumers that they may, and should, comparison shop.

H. *Interest Rate and Payment Summary*

1. Introduction

The Interest Rate and Payment Summary section described in Proposed Regulation Z § 226.38(c) is one of the most significant departures from the existing disclosure format. The proposal replaces the existing payment schedule with a new table format, adds new interest rate and escrow disclosures, and imposes a new requirement "to disclosure the maximum possible interest rate and payments" for ARMs after the initial rate expires.[286] Proposed subsection (c) is a good start, based on good concepts, but a close examination shows the need for improvement and further consumer testing. We encourage the Board to treat the Interest Rate and Payment Summary as a work in progress and to continue testing other possible formats.

2. Maximum Payment Disclosures Are Very Important

We congratulate the Board for its new emphasis on disclosing the maximum possible monthly payment in a prominent place within the grouped and segregated disclosures. This change will hopefully counteract borrowers' natural tendency to underestimate the effect that rate increases could have on their payments.[287] As further explained below, however, the format of the payment disclosures falls short of their goal. Borrowers rely heavily on the monthly payment disclosure when trying to decide whether they can afford a loan.[288] While consumers have difficulty understanding the impact of rates and total payments on a loan, consumers intuitively understand monthly payments.[289]

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[286] *See* 74 Fed. Reg. at 43,264 (discussing proposed Regulation Z § 226.38(c)).
[287] Elizabeth Renuart and Diane E. Thompson, The Truth, the Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending, 25 Yale J. on Reg. 181, 211–213 (2008).
[288] *See* Ren S. Essene & William Apgar, Joint Ctr. for Housing Studies, Harvard Univ., Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans 20 (2007); Lauren E. Willis, Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price, 65 Md. L. Rev. 707, 788–789 (2006).
[289] *See* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 Md. L. Rev. 707, 781–782 (2006). Consumers often have trouble intuitively understanding large numbers, particularly when those large numbers do not need to be paid until well into

Monthly payments are stated in dollar amounts. Those dollar amounts mean something to consumers in their budgets. Moreover, the scale of the maximum monthly payment is within the daily experiences of most borrowers. Maximum monthly payments are large numbers, but not so large as to lose all meaning for borrowers. The monthly payment, for many borrowers, is the key number for measuring a loan's affordability and reflects in real terms what consumers can expect as a worst case scenario so consumers may evaluate their own risk tolerance. While we strongly support the prominence accorded the maximum payment disclosures, we nevertheless encourage the Board to consider testing alternative disclosure formats for all ARMs, but especially for POARMs and all other negative amortization loans. As explained in more detail below, the maximum payment and balance disclosures for such loans are flawed and need revision.

3. Require Disclose of Escrow Amount for All Loans Regardless of Whether Creditor Establishes an Escrow Account

The proposed regulations include some escrow disclosure requirements but they are insufficient. Consumers need two types of escrow disclosure: a statement of whether the loan will include an escrow account, and disclosure of what the monthly escrow payments will be. Escrow disclosures are important—even where the creditor does not require an escrow account—because virtually all borrowers must pay property taxes and insurance (T&I) for their home. When creditors do not collect the T&I payments through an escrow account, experience has shown that many consumers fail to budget for these payments when calculating loan affordability, or they mistakenly assume the lender has already included escrow payments in the disclosed periodic payment amount.

Predatory lenders have taken advantage of this by refinancing loans that include escrow accounts with new—more expensive—loans that do not include escrow accounts. When the consumer sees a disclosure statement reflecting the principal and interest (P&I) payment for the new loan, he is often deceptively encouraged to compare it to the payment on his existing loan (the one being refinanced). If the payment on the old loan includes, interest, taxes, and insurance (PITI), the new P&I payment will appear more affordable than the old PITI payment on a strictly numerical basis *unless* the disclosure statement clearly warns the borrower that the new P&I payment does not include escrow. This "escrow not included" warning should be in close proximity to the payment amount and should include the estimated cost of T&I.

Because the Board does not currently require this disclosure, consumers often fail to realize the new loan is more expensive until they receive a notice of delinquent tax

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the future. Rates, while extremely important for comparative purposes, are less helpful when borrowers want to manipulate the numbers and determine their actual payment amounts. Most consumers have trouble performing even simple mathematical operations using percentages. Leda Cosmides & John Tooby, *Are Humans Good Intuitive Statisticians After All? Rethinking Some Conclusions from the Literature on Judgment Under Uncertainty*, 58 Cognition 1, 18 (1996); Justin Kruger & Patrick Vargas, *Consumer Confusion of Percent Differences*, 18 J. Consumer Psychol. 1 (2008) (also available at http://ssrn.com/abstract=946238).

payments or that their insurance is being canceled for non-payment. This has a domino effect that often leads to the servicer establishing an escrow account with expensive force-placed insurance. This causes the borrower's monthly payments to increase which then pushes the borrower into default and foreclosure.

As proposed, creditors must disclose: "That an escrow account is required, if applicable, and an estimate of the amount of taxes and insurance, including any mortgage insurance[.]" Proposed Regulation Z §§ 226.38(c)(3)(i)(C). In addition, the proposed commentary says a creditor need only make the escrow disclosures if the creditor plans to open an escrow account. Proposed Official Staff Commentary § 226.38(c)(3)(i)(C)-1.[290] The failure to require any escrow-related disclosures (on the first page) for loans *without* an escrow account is a major omission. To help consumers protect themselves from the above-described scam, the Board must require: a) disclosure of the same escrow payment information as required for loans with escrow accounts; and b) a clear, prominent warning that the loan does not include an escrow account and that the borrower must make the T&I payments on their own.

Although the Board proposes requiring creditors to state whether the loan includes an escrow account, the statement will go on the back, or second page, of the disclosure form and will be too inconspicuous and to protect consumers. *See* Proposed Regulation Z § 226.38(e)(3). We believe the absence of an escrow account is important enough to require a prominent notice on the first page of disclosures, along with the other payment information.[291]

4. Negative Amortization and Payment Option Disclosures Are Deeply Flawed

a. *Interest and Payment Disclosures Are Confusing, Incompatible with Amortizing ARM Disclosures, and Incomplete*

As previously indicated, the only way to correct the disclosures for negative amortization and payment option loans is to delete them entirely and ban this type of loan product. If the Board continues to allow negative amortization loans, however, the interest and payment disclosures should be re-evaluated and subjected to additional consumer testing.

The proposed disclosures for amortizing, adjustable-rate mortgages will show the interest rate and periodic payment amount for the introductory rate; the maximum rate and payment at the first adjustment; and the maximum rate and payment that may ever come into existence at any time until the loan matures. While those disclosures appropriately educate the consumer on the potential cost of an ARM, Proposed

[290] The proposed commentary says "An estimated payment amount for taxes and insurance must be disclosed if the creditor will establish an escrow account for such amounts." Proposed Official Staff Commentary § 226.38(c)(3)(i)(C)-1.

[291] For loans with escrow accounts, the second page of the proposed model form should identify the Settlement Statement by name rather than merely by form number ("HUD-1 Form"). Few consumers will recognize the form number alone. *See, e.g.,* Proposed Regulation Z Model Form H-19(G) at 2 (74 Fed. Reg. 43,362).

Regulation Z § 226.38(c) falls short of TILA's mandate to facilitate comparison between different loans because it will be hard for consumers to compare the ARM disclosures to the negative amortization disclosures. The negative amortization disclosures will use different labels and different columns, and will not clearly identify the maximum payment. Additionally, the phrase "minimum payment" on the payment option disclosures could be confusing to consumers familiar with how the same phrase is used on credit card statements. On a credit card, the "minimum payment" will eventually pay off the total balance (assuming no new purchases or fees). On a POARM, however, the "minimum payment" does not pay off the balance—instead it makes the balance grow larger.

The way a negative amortization loan reaches the maximum possible payment is also more complex and difficult to explain to consumers than the maximum payment on fully-amortizing ARMs. If a borrower does not understand the circumstances under which a loan could reach the maximum possible payment, the borrower will not be able to evaluate the risk posed by the loan terms. The proposed model form sample for a POARM (H-19(I)) appears to disclose the maximum payment by assuming the interest rate reaches the maximum possible interest rate as early as possible—a rate of 10.5% in the second month of the loan. However, that would not produce the maximum possible payment for a typical POARM.

For most ARMs, the maximum payment should be calculated by applying the maximum interest rate permitted by the note to the remaining principal balance, assuming payments will be made as agreed under the note on the earliest date that the maximum interest rate could apply. In contrast, for payment option ARMs, the maximum payment depends on the interplay between the permissible amount of negative amortization, the highest interest rate, and the latest date at which the payments become fully amortizing. The maximum payment for payment option ARMs is triggered when the maximum interest rate is applied to the maximum loan balance for the shortest duration. This will happen when the onset of fully amortizing payments is delayed as long as possible, but still after reaching the maximum loan balance.

For most payment option ARMs, the maximum payment should be calculated applying the maximum interest rate to the maximum negative amortization after the longest permissible period of time for non-fully amortizing payments, typically five years. For example, if the original loan amount was $200,000 and the minimum monthly payment was $690.24 with an initial rate of 1.5% interest for the first payment, this loan would reach the maximum possible payment under the terms of the note on the 61st payment if the interest rate rose to about 6.77% on the first adjustment and remained the same until the 61st month when it rose again to 10.5%. This maximum possible payment on this loan would be $2,171.19 and the maximum principal balance would be $229,795.10. In the absence of a clear explanation of these details, a borrower comparing a fully-amortizing ARM and a POARM would not be able to accurately evaluate the risk posed by the differing loan terms and payment options.

Negative amortization disclosures are further complicated by the differences between the various payment options. While the Board's proposal to disclose only the full and minimum payment options is logical, the proposed disclosures fail to explain that the disclosed full payment amount will increase if the borrower makes less than the full payment at any time during the option period. If the borrower elects to make the minimum payment (or any amount less than the full payment) just once, negative amortization will increase the loan balance and the full payment will increase in order to remain a fully amortizing payment. As a result, the Board's attempt to simplify the disclosures by omitting lengthy explanations results in a potentially misleading disclosure.

b. *Improve Disclosure of Amount by Which Principal Balance Will Increase*

For loans permitting negative amortization, the Board also proposes to require creditors to disclose the amount by which the principal balance will increase "if the consumer makes only the minimum required payments for the maximum possible time, and the earliest date on which the consumer must make a fully amortizing payment, *assuming that the interest rate reaches its maximum at the earliest possible time.*" Proposed Regulation Z § 226.38(c)(6)(ii). This disclosure is intended to show "the maximum possible balance . . . to help ensure that consumers understand the nature and risks involved in loans with negative amortization."[292] While we agree that showing the maximum possible balance will help consumers, the proposed methodology will not show the maximum possible balance for the reasons explained above.

The proposed statement to accompany this disclosure must also be changed. The proposed model form warns consumers they "will borrow" additional money by a certain date if the borrower only makes the minimum payments. This statement should be redesigned to avoid potential misinterpretation and so it has a more powerful impact on readers. The phrase "will borrow" could be misinterpreted by unsophisticated borrowers as an inducement to make the minimum payments—a consumer could read the statement as meaning the lender will give them more cash (as with a HELOC) by the listed date only if they make the minimum payments. Although this disclosure may be technically correct in the sense that negative amortization can be considered a further extension of credit, using the word "borrow" in this way is vastly different from the common understanding of the word. As a result, we encourage the Board to use consumer testing to find other ways to make these disclosures.

5. Clarify Definition of "Amortizing Loan"

The definition of "amortizing loan" in Proposed Regulation Z § 226.38(c)(7)(ii) is contrary to the normal understanding of the term and should be changed to avoid confusion. For purposes of the new Interest Rate and Payment Summary in Proposed Regulation Z § 226.38(c), the proposed rule defines an "amortizing loan" as a loan in which the regular payments cannot cause negative amortization. This means that loans traditionally not considered amortizing (such as interest-only notes) are "amortizing

[292] 74 Fed. Reg. at 43,304.

loans" for purposes of the Interest Rate and Payment Summary. Proposed Regulation Z § 226.38(c)(7)(ii); Official Staff Commentary § 226.38(c)-2. An amortizing loan is generally considered one in which regular monthly payments of principal and interest will retire the loan by its maturity date. The proposed definition is not necessary and opens the door to confusion. Proposed paragraph (c) would be easier to understand if the Board deleted the proposed definition and simply used more commonly recognized terminology, such as "loans that permit negative amortization," "amortizing loans," and "interest-only loans."

6. Require a More Prominent Teaser Rate Warning

The proposed disclosure for discounted introductory rates (more commonly known as teaser rates) is inadequate. While we are pleased that the Board has proposed adding a teaser rate notice, the Board should make it stronger and more prominent. Proposed Regulation Z § 226.38(c)(2)(iii) requires only "[a] statement that even if market rates do not change, the interest rate will increase at the first adjustment and the date of such rate adjustment; and [t]he fully-indexed rate." The model form shows this notice in fine print below the interest and payment table. While this shows the fully-indexed rate, it does not show the resulting payment, which could be different from the maximum possible at the first adjustment, and does not clearly convey that some loans have a guaranteed rate increase at the first adjustment.

We recognize that the Board tested alternative payment disclosure in Round 8 of the consumer testing, but we are concerned that the Board abandoned the tests too soon—after only one round. ICF Macros's report says "almost all participants understood from both the [tested] table and graph that even if market rates stayed the same, their payment would increase . . . . Several [participants] indicated that this surprised them, because this was not apparent from the first page of the TILA." ICF Macro p.31. These observations are important for a number of reasons. The "first page of the TILA" used a payment and interest table very similar to the one adopted by the Board for the proposed regulations. The participants' observations indicate that the tested graph and table educated consumers on an important detail that the proposed disclosure table does not explain.

Because ICF did not conduct further testing on the graph or table from Round 8, we cannot know whether those disclosures were better than the introductory rate notice ultimately adopted or whether any of the flaws identified could be remedied. There was also no testing on whether the introductory rate notice would be more effective if it included the resulting payment and was in larger, bold letters elsewhere on the form. Before adopting final regulations, the Board should further test these and other ways to disclose the effect of teaser rates including variations of the payment disclosure table with more detail regarding whether the rate stays the same or increases to the maximum, a disclosure that shows only the initial and maximum payment without any intermediate adjustments, and the previously described details regarding the maximum possible payment on POARMs.

I. *Itemization of Amount Financed*

1. Overview

The proposed regulations include the existing option for mortgage creditors to substitute RESPA's GFE and HUD-1 for TILA's itemization of the amount finance. We support continuing to allow this alternative, but *only* if the Board adopts the all-in finance charge as discussed in Section IV and creditors are required to provide the HUD-1 at least 3 days in advance of the closing, as discussed in § VI, *supra.*[293] Closing costs can be significant so it is important to give borrowers information about them in advance of the closing date while there is still time to correct errors and make changes. As long as the closing costs have been incorporated into the APR, the HUD-1 will provide sufficient detail to meet borrower needs. If the Board weakens or does not adopt the all-in finance charge, the Board should require creditors to automatically provide an itemization for all transactions and should eliminate the alternatives.

Proposed Regulation Z § 226.38(j)(1) is generally the same as the current Regulation Z § 226.18(c). Both give closed-end mortgage creditors three options: provide an itemization of the amount financed, a statement that the consumer may request an itemization, or comply with RESPA's rules for providing a good faith estimate and settlement statement (Form HUD-1 or HUD-1A).

2. If Board Adopts All-In Finance Charge, Clarify Language of RESPA Alternative

The current and proposed rules both contain some ambiguity regarding which RESPA disclosures may be substituted for the itemization requirement. While the Commentary clarifies this ambiguity, it would be better to eliminate it. This can easily be accomplished without changing the meaning of the rule. Currently Regulation Z § 226.18(c) requires creditors to provide a "separate written itemization of the amount financed," but adds in a footnote: "Good faith estimates of settlement costs provided for transactions subject to [RESPA] may be substituted . . . ."[294] In doing so, it appears to say the only approved substitute is the good faith estimate—not the final HUD-1. Proposed Regulation Z § 226.38(j)(1)(iii) permits substitution of "A good faith estimate of settlement costs provided under [RESPA] . . . *or* the HUD-1 settlement statement provided under RESPA . . . ." (Emphasis added). The word "or" appears to create two options: provide a GFE *or* a HUD-1 in lieu of the itemization.

The current Official Staff Commentary § 228.18(c) clarifies that RESPA compliance is only a substitute for the itemization if creditors provide *both* the GFE and HUD-1. The Proposed Official Staff Commentary to Regulation Z § 226.38(j)(1), however, makes the issue more confusing because two passages of the Commentary are in conflict. The current Official Staff Commentary § 226.18(c) says "[t]ransactions

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[293] *See* Proposed Official Staff Commentary § 226.38(j)(1)-1 ("the HUD-1 settlement statement satisfies this [itemization] requirement only if it is provided to the consumer at the time required by § 226.19(a)(2)," i.e., "no later than three business days before consummation.").
[294] Regulation Z § 226.18(c)(1) n.40.

subject to RESPA are exempt from the requirements of Regulation Z § 226.18(c) if the creditor complies with RESPA's requirements for a good faith estimate *and* settlement statement." Official Staff Commentary § 226.18(c)-4 (emphasis added). Proposed Official Staff Commentary § 226.38(j)(1) confusingly says "The creditor may substitute the GFE *or* HUD-1 settlement statement for the itemization." Proposed Official Staff Commentary § 226.38(j)(1)-1(iii) (emphasis added). That paragraph refers to Proposed Official Staff Commentary § 226.38(j)(1)(iii)-1 which, in contrast, states "the creditor can satisfy § 226.38(j)(1) if the creditor complies with RESPA's requirement for a good faith estimate *and* settlement statement." Official Staff Commentary § 226.38(j)(1)(iii)-1 (emphasis added). As a result, Proposed Official Staff Commentary § 226.38(j)(1)-1(iii) and Proposed Official Staff Commentary § 226.38(j)(1)(iii)-1 appear to conflict. A 1997 amendment to Official Staff Commentary § 226.18(c) added a reference to the HUD-1. Prior to the amendment, the Commentary only mentioned the GFE. Therefore, the amendment shows the GFE is not intended to be an adequate substitute by itself.[295] To resolve these problems, the Board should replace "or" with "and" in both Proposed Regulation Z § 226.38(j)(1)(iii) and Proposed Official Staff Commentary § 226.38(j)(1)-1(iii).

3. If the Board Does Not Adopt, or Weakens, the All-In Finance Charge Definition, It Should Require the Itemization for All Mortgage Transactions

If the final version of the proposed rules does not include a strong all-in definition of the finance charge, the Board should replace Proposed Regulation Z § 226.38(j)(1) with a new requirement that all mortgage creditors automatically provide consumers with an itemization of the amount financed. Because the HUD-1 has been redesigned, it is no longer an appropriate substitute for the itemization. The option permitting creditors to merely make a statement that the consumer may receive an itemization upon request is also insufficient and should be eliminated.

On November 17, 2008, the Department of Housing and Urban Development (HUD) released final changes to its RESPA regulations.[296] Among other things, HUD revised the format of the settlement statements that lenders must provide to borrowers at the mortgage loan closings.[297] The new HUD-1 and HUD-1A require the "loan originator" to bundle all "origination" charges and disclose them on line 801. Charges for "origination" services include a wide array of fees that currently are itemized, many of which are finance charges under the Board's current interpretation but some of which are not. HUD defines origination service as "any service involved in the creation of the mortgage loan, including but not limited to the taking of the loan application, loan processing, and the underwriting and funding of the loan, and the processing and administrative services required to perform these functions."[298]

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[295] 62 Fed. Reg. 10,193, 10,197 (Mar. 6, 1997).
[296] 73 Fed. Reg. 68,204 (Nov. 17, 2008). Most of these changes are effective on January 1, 2010.
[297] *Id.* at 68,241, 68,243–68,249.
[298] 24 C.F.R. § 3500.2(b). "Loan originator" includes both a lender and a mortgage broker.

As a result, the HUD-1 will no longer itemize the fees most often listed in the "800" and "1300" series on the current form with the exception of the appraisal, credit report, tax service, flood certification fees.[299] These latter fees are recorded on the new form in lines 804–807. Lines 808 and following may contain fees for other third party services required by the loan originator. However, origination services performed by the lender and the broker are lumped into lines 801.

The bundling of the origination fees presents concerns under the Truth in Lending Act. Because most origination fees will be added together on the new GFE and settlement statement, supervisory agencies and consumers (and their advocates) will have a difficult time determining if the TIL "federal box" disclosures are accurate. The two key disclosures of the cost of credit are the finance charge and the APR. Currently, the Official Staff Commentary allows lenders to forego giving consumers an itemization of the amount financed (which lists all items included in the amount financed disclosure plus the total of all prepaid finance charges) in loans to which RESPA applies and where the lender has provided the consumer with a RESPA good faith estimate and settlement statement.[300] Because the new GFE and settlement statement require fee bundling for origination charges, they no longer adequately substitute for the itemization of the amount financed. Even if the HUD-1 is provided in advance of consummation, the content of the new HUD-1 is not an acceptable substitute, unless the Board adopts the all-in finance charge proposal. The Federal Reserve Board should change the proposed rule and its Commentary to reflect this new reality.

The Board seeks comment on how the option of providing a HUD-1 instead of an itemization might be structured without requiring creditors to provide the HUD-1 earlier than RESPA requires, while also preserving the purposes of the MDIA.[301] In our opinion, if the HUD-1 alternative is retained, the FRB should also retain the requirement to provide it at least 3 business days in advance of the closing, with the rest of the TIL disclosures. Abandoning that requirement would be contrary to the purposes of MDIA. We do not believe there is any way to restructure the alternative and continue to adhere to the concept that early disclosures are necessary without requiring creditors to provide the HUD-1 early.

4. Abolish the "Provide Nothing" Option—Regardless of What Happens to the All-In Finance Charge Definition

Regardless of whether the Board allows creditors to provide a HUD-1 as a substitute for the itemization, the Board should eliminate the option of providing a "statement that the consumer has the right to receive a written itemization . . . ." Proposed Regulation Z § 226.38(j)(1)(ii). If the itemization is important enough to require the creditor to provide it (or a substitute) on request, it should be provided automatically. Providing it automatically will save time and will facilitate the

[299] 73 Fed. Reg. at 68,244–68,245 (Appendix A to Part 3500--Instructions for Completing HUD-1 and HUD-1A Settlement Statements; Sample HUD-1 and HUD-1A Statements).
[300] Official Staff Commentary § 226.18(c)-4.
[301] 74 Fed. Reg. at 43,314.

standardization of industry procedures. The itemization will be generated from the information already used by the creditor to generate the other TIL disclosures so producing the itemization will not impose any noteworthy burden on creditors.

In addition, requiring it to be automatically provided will resolve some logistical problems inherent in the rule as proposed. The proposed regulation specifies that, if a consumer requests the itemization, the creditor must provided it "at the same time as the other disclosures required by this section." While laudable, this requirement creates confusion because (j) also says the creditor can provide the statement (that an itemization is available) at the same time as the other disclosures. Consumers generally will not request the itemization until they have received the disclosure notifying them of the right to request it, so the itemization could not be provided at the same time as the other disclosures unless all the disclosures are re-issued. If the disclosures are re-issued, or even if the itemization could be provided independently, that would probably require rescheduling the closing. Creditors or mortgage brokers would likely use this delay to discourage consumers from requesting the itemization. Instead the itemization should be automatically provided as it currently is with non-mortgage, closed-end credit.

J. *Key Questions About Risk Are Useful but Insufficient*

Overall, we support the "Key Questions About Risk" disclosure, Proposed Regulation Z § 226.38(d). With some improvements it will alert consumers to significant loan features that are associated with a heightened risk of default or an increased cost of credit. While some of these features can be determined from the disclosure statement currently in use, the proposal should increase the chance that consumers will learn about these risks.

1. Improve the Negative Amortization Warning

One aspect that should be improved is the disclosure of negative amortization. As previously explained, loans permitting negative amortization should be explicitly banned. It is impossible to adequately explain this risk to the typical consumer. Nevertheless, if the Board continues to permit this type of loan product, the Board should change the explanation on the proposed model form, sample H-19(I).[302] The current answer is:

> "**YES**. Your minimum payment covers only part of the interest you owe each month and none of the principal. The unpaid interest will be added to your loan amount, which over time will increase the total amount you are borrowing and cause you to lose equity in your home." *Id*. (emphasis in original).

This answer does not make the risk sufficiently clear and the reference to "increas[ing] the total amount you are borrowing" is confusing. The risk is not loss of equity—the risk is loss of the house. The common understanding of "borrowing" refers to the actual receipt of funds from a lender that the consumer may spend elsewhere. While negative amortization may technically involve an extension of credit, it is not the

[302] 74 Fed. Reg. at 43,336.

equivalent of "borrowing" as understood by the general public. Instead the disclosure should use a more direct explanation with different terminology, such as:

> "**YES.** The minimum payment is too small to pay-off this loan. If you do not make the ***full payment***, the balance will get bigger each month and you will risk losing your house. You have the right to ask for a loan that does not have this risky feature."

2. The Balloon Payment Warning Is Incomplete

The balloon payment warning is appropriate but it must include a warning that there is no guarantee the consumer will be able to refinance before the balloon payment comes due. There have been many reports that predatory lenders and brokers assuage borrower concern about balloon payments with false promises that the originator will help the borrower refinance.

3. "No Escrow Account" Warning Is Inadequate

As explained in XII.H.3, *supra,* in greater detail, the Board should do a better job alerting consumers when a loan does not include an escrow account. There are grave consequences to signing a loan with the mistaken believe that the monthly payments include escrow. While the proposed disclosure is much better than nothing—which is what consumers are currently told—the disclosure should appear on the first page in the interest and payment summary.

K. *Require Creditors to Include Their Contact Information When Identifying Themselves in the Grouped and Segregated Disclosures*

Proposed Regulation Z § 226.38(g) requires creditors to identify themselves and the loan originator on loan disclosures. Proposed Official Staff Commentary § 226.38(g)(1)-1 says the creditor's name is sufficient without an address or telephone number. The Board, however, has requested comment on whether creditors should be required to provide their contact information as well.[303] We are pleased to see that the Board has adopted this rather simple but important requirement. We encourage the Board to also require creditors to provide their contact information in close proximity to their identification. The creditor's name is insufficient given the profusion of similar-sounding creditor names, d/b/as, and interstate lenders. Consumers cannot simply look the lender up in the phonebook to find their contact information.

The same section also requires "[t]he loan originator's unique identifier, as defined by the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 Sections 1503(3) and (12), 12 U.S.C. 5102(3) and (12)." Curiously, nothing in the regulation says where the loan originator's identifier should be disclosed. Proposed Regulation Z § 226.17(a)(1) requires the creditor's identity to appear with the grouped and segregated disclosures for all loans, but that section does not mention the loan

[303] 74 Fed. Reg. at 43,311.

originator's identification. We recommend requiring the loan originator's identifier to appear in the same location as the creditor's identity. The SAFE Act ID number requirement is very important considering that originators are not necessarily employed by the lender and not be known to the consumer. Requiring originators to identify themselves is important for accountability.

L. *Extend Limit on Advance Payments to All Mortgage Loans*

Advance payments, as defined in Regulation Z § 226.32(d)(3), are "[a] payment schedule that consolidates more than two periodic payments and pays them in advance from the proceeds." Requiring advance payments is rightly prohibited by Regulation Z, but only for loans within the scope of HOEPA. We strongly encourage the Board to extend this same prohibition to all mortgages or—at a minimum, higher-priced mortgage loans. Advance payments are abusive. Creditors requiring advance payments are charging consumers for the funds the consumer is never able to access and from which the consumer receives no tangible benefit. It is likely that creditors requiring many months of advance payments are doing so because the creditor plans to sell the loan on the secondary market but fears the consumer will default before the creditor's repurchase agreement expires.

The abusive and highly inappropriate nature of these loans and how they often accompany other abusive practices is clearly illustrated in the recent case of *Williams v. Aries Financial, LLC et al*.,[304] in which a predatory lender originated a loan to a residential homeowner and "placed $37,620 of the mortgage proceeds into an escrow account, from which it paid itself interest-only payments on the mortgage for a year" as part of a foreclosure rescue scam.[305] Currently TILA permits this practice for non-HOEPA loans. Existing Regulation Z § 226.18(r) and Proposed Regulation Z § 226.38(i)[306] provide no more protection than a weak notice requirement riddled with exceptions. There is no legitimate reason for allowing this practice to continue so we call on the Board to extend the limit now applicable to HOEPA loans to all loans.

XIII. CONCLUSION

We commend the Board for the crucial changes it has proposed and urge the Board to adopt the additional changes set forth above.

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[304] No. 09-CV-1816 (JG) (RML), 2009 WL 3851675 (E.D.N.Y. Nov. 18, 2009).

[305] *Id.* at *2. This court decision does not discuss the legality of the advance payments.

[306] The existing Official Staff Commentary § 226.18(r), the Proposed Official Staff Commentary § 226.38(i), and the case of *Therrien v. Resource Financial Group*, illustrate the confusion over the difference between this arrangement is a finance charge like a consumer buydown or a pledged account mortgage, which can be treated as a required deposit. *See Therrien*, 704 F. Supp. 322 (D.N.H. 1989) (24-month loan consisting of 23 interest-only payments followed by a balloon payment in which creditor impounded 16 months of payments from loan proceeds). *See also* National Consumer Law Center, Truth in Lending § 3.9.6.2.6 (6th ed. 2007 and Supp.) (discussing *Therrien*).

APPENDIX I

Williams Adjustable Rate Note

SEE "PREPAYMENT PENALTY ADDENDUM T[redacted]TE" ATTACHED HERETO AND MADE A PART HE[redacted].

LOAN NO.: [redacted]

MIN: [redacted]
MERS Phone: [redacted]

ADJUSTABLE RATE NOTE
(MTA - Twelve Month Average Index - Payment Caps)

THIS NOTE CONTAINS PROVISIONS THAT WILL CHANGE THE INTEREST RATE AND THE MONTHLY PAYMENT. THERE MAY BE A LIMIT ON THE AMOUNT THAT THE MONTHLY PAYMENT CAN INCREASE OR DECREASE. THE PRINCIPAL AMOUNT TO REPAY COULD BE GREATER THAN THE AMOUNT ORIGINALLY BORROWED, BUT NOT MORE THAN THE MAXIMUM LIMIT STATED IN THIS NOTE.

AUGUST 18, 2006
[Date]

[redacted]
[City]

[redacted], KY 41042
[Property Address]

CERTIFIED TO BE A TRUE AND EXACT COPY OF THE ORIGINAL
BY: [redacted]

1. BORROWER'S PROMISE TO PAY

In return for a loan that I have received, I promise to pay U.S. $ 425,000.00 (this amount is called "Principal"), plus interest, to the order of Lender. The Principal amount may increase as provided under the terms of this Note but will never exceed ONE HUNDRED FIFTEEN AND 000/1000THS (115.000 %) of the Principal amount I originally borrowed. This is called the "Maximum Limit." Lender is MORTGAGEIT, INC.

I will make all payments under this Note in the form of cash, check or money order.

I understand that Lender may transfer this Note. Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note is called the "Note Holder."

2. INTEREST

(A) Interest Rate

Interest will be charged on unpaid Principal until the full amount of Principal has been paid. I will pay interest at a yearly rate of 2.000 %. The interest rate I will pay may change.

The interest rate required by this Section 2 is the rate I will pay both before and after any default described in Section 7(B) of this Note.

(B) Interest Rate Change Dates

The interest rate I will pay may change on the 1st day of OCTOBER, 2006, and on that day every month thereafter. Each date on which my interest rate could change is called an "Interest Rate Change Date." The new rate of interest will become effective on each Interest Rate Change Date. The interest rate may change monthly, but the monthly payment is recalculated in accordance with Section 3.

(C) Index

Beginning with the first Interest Rate Change Date, my adjustable interest rate will be based on an Index. The "Index" is the "Twelve-Month Average" of the annual yields on actively traded United States Treasury Securities adjusted to a constant maturity of one year as published by the Federal Reserve Board in the Federal Reserve Statistical Release entitled "Selected Interest Rates (H.15)" (the "Monthly Yields"). The Twelve Month Average is determined by adding together the Monthly Yields for the most recently available twelve months and dividing by 12. The most recent Index figure available as of the date 15 days before each Interest Rate Change Date is called the "Current Index".

If the Index is no longer available, the Note Holder will choose a new index that is based upon comparable information. The Note Holder will give me notice of this choice.

(D) Calculation of Interest Rate Changes

Before each Interest Rate Change Date, the Note Holder will calculate my new interest rate by adding THREE AND 450/1000THS percentage point(s) (3.450 %) ("Margin") to the Current Index. The Note Holder will then round the result of this addition to the nearest one-eighth of one percentage point (0.125%). This rounded amount will be my new interest rate until the next Interest Rate Change Date. My interest will never be greater than 9.950 %. Beginning with the first Interest Rate Change Date, my interest rate will never be lower than the Margin.

Initials: [redacted]

3. PAYMENTS

(A) Time and Place of Payments

I will make a payment every month.

I will make my monthly payments on the 1st day of each month beginning on OCTOBER, 2006 . I will make these payments every month until I have paid all the Principal and Interest and any other charges described below that I may owe under this Note. Each monthly payment will be applied as of its scheduled due date and will be applied to interest before Principal. If, on SEPTEMBER 01, 2036 , I still owe amounts under this Note, I will pay those amounts in full on that date, which is called the "Maturity Date."

I will make my monthly payments at MORTGAGEIT, INC.
PO BOX 79135, PHOENIX, AZ 85062-9135
or at a different place if required by the Note Holder.

(B) Amount of My Initial Monthly Payments

Each of my initial monthly payments until the first Payment Change Date will be in the amount of U.S. $ 1,570.88 unless adjusted under Section 3(F).

(C) Payment Change Dates

My monthly payment may change as required by Section 3(D) below beginning on the 1st day of OCTOBER, 2007 , and on that day every 12th month thereafter. Each of these dates is called a "Payment Change Date." My monthly payment also will change at any time Section 3(F) or 3(G) below requires me to pay a different monthly payment. The "Minimum Payment" is the minimum amount the Note Holder will accept for my monthly payment which is determined at the last Payment Change Date or as provided in Section 3(F) or 3(G) below. If the Minimum Payment is not sufficient to cover the amount of the interest due then negative amortization will occur.

I will pay the amount of my new Minimum Payment each month beginning on each Payment Change Date or as provided in Section 3(F) or 3(G) below.

(D) Calculation of Monthly Payment Changes

At least 30 days before each Payment Change Date, the Note Holder will calculate the amount of the monthly payment that would be sufficient to repay the unpaid Principal that I am expected to owe at the Payment Change Date in full on the maturity date in substantially equal payments at the interest rate effective during the month preceding the Payment Change Date. The result of this calculation is called the "Full Payment." Unless Section 3(F) or 3(G) apply, the amount of my new monthly payment effective on a Payment Change Date, will not increase by more than 7.5% of my prior monthly payment. This 7.5% limitation is called the "Payment Cap." This Payment Cap applies only to the Principal and Interest payment and does not apply to any escrow payments Lender may require under the Security Instrument. The Note Holder will apply the Payment Cap by taking the amount of my Minimum Payment due the month preceding the Payment Change Date and multiplying it by the number 1.075. The result of this calculation is called the "Limited Payment." Unless Section 3(F) or 3(G) below requires me to pay a different amount, my new Minimum Payment will be the lesser of the Limited Payment and the Full Payment. I also have the option to pay the Full Payment for my monthly payment.

(E) Additions to My Unpaid Principal

Since my monthly payment amount changes less frequently than the interest rate, and since the monthly payment is subject to the payment limitations described in Section 3(D), my Minimum Payment could be less than or greater than the amount of the interest portion of the monthly payment that would be sufficient to repay the unpaid Principal I owe at the monthly payment date in full on the Maturity Date in substantially equal payments. For each month that my monthly payment is less than the interest portion, the Note Holder will subtract the amount of my monthly payment from the amount of the interest portion and will add the difference to my unpaid Principal, and interest will accrue on the amount of this difference at the interest rate required by Section 2. For each month that the monthly payment is greater than the interest portion, the Note Holder will apply the payment as provided in Section 3(A).

(F) Limit on My Unpaid Principal; Increased Monthly Payment

My unpaid Principal can never exceed the Maximum Limit equal to ONE HUNDRED FIFTEEN AND 000/1000THS percent (115.000 %) of the Principal amount I originally borrowed. My unpaid principal could exceed that Maximum Limit due to

Initials: [redacted]

Minimum Payments and interest rate increases. In that event, on the date that my paying my monthly payment would cause me to exceed that limit, I will instead pay a new monthly payment. This means that my monthly payment may change more frequently than annually and such payment changes will not be limited by the 7.5% Payment Cap. The new Minimum Payment will be in an amount that would be sufficient to repay my then unpaid Principal in full on the Maturity Date in substantially equal payments at the current interest rate.

(G) Required Full Payment

On the fifth Payment Change Date and on each succeeding fifth Payment Change Date thereafter, I will begin paying the Full Payment as my Minimum Payment until my monthly payment changes again. I also will begin paying the Full Payment as my Minimum Payment on the final Payment Change Date.

(H) Payment Options

After the first Interest Rate Change Date, Lender may provide me with up to three (3) additional payment options that are greater than the Minimum Payment, which are called "Payment Options." I may be given the following Payment Options:

(i) Interest Only Payment: the amount that would pay the interest portion of the monthly payment at the current interest rate. The Principal balance will not be decreased by this Payment Option and it is only available if the interest portion exceeds the Minimum Payment.

(ii) Fully Amortized Payment: the amount necessary to pay the loan off (Principal and Interest) at the Maturity Date in substantially equal payments.

(iii) 15 Year Amortized Payment: the amount necessary to pay the loan off (Principal and Interest) within a fifteen (15) year term from the first payment due date in substantially equal payments. This monthly payment amount is calculated on the assumption that the current rate will remain in effect for the remaining term.

These Payment Options are only applicable if they are greater than the Minimum Payment.

4. NOTICE OF CHANGES

The Note Holder will deliver or mail to me a notice of any changes in the amount of my monthly payment before the effective date of any change. The notice will include information required by law to be given to me and also the title and telephone number of a person who will answer any question I may have regarding the notice.

5. BORROWER'S RIGHT TO PREPAY

I have the right to make payments of Principal at any time before they are due. A payment of Principal only is known as a "Prepayment." When I make a Prepayment, I will tell the Note Holder in writing that I am doing so. I may not designate a payment as a Prepayment if I have not made all the monthly payments due under this Note.

I may make a full Prepayment or partial Prepayments without paying any Prepayment charge. The Note Holder will use my Prepayments to reduce the amount of Principal that I owe under this Note. If I make a partial Prepayment, there will be no changes in the due dates of my monthly payments. My partial Prepayment may reduce the amount of my monthly payments after the first Payment Change Date following my partial Prepayment. However, any reduction due to my partial Prepayment may be offset by an interest rate increase.

6. LOAN CHARGES

If a law, which applies to this loan and which sets maximum loan charges, is finally interpreted so that the interest or other loan charges collected or to be collected in connection with this loan exceed the permitted limits, then: (a) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (b) any sums already collected from me that exceeded permitted limits will be refunded to me. The Note Holder may choose to make this refund by reducing the Principal I owe under this Note or by making a direct payment to me. If a refund reduces Principal, the reduction will be treated as a partial Prepayment.

7. BORROWER'S FAILURE TO PAY AS REQUIRED

(A) Late Charges for Overdue Payments

If the Note Holder has not received the full amount of any monthly payment by the end of FIFTEEN (15) calendar days after the date it is due, I will pay a late charge to the Note Holder. The amount of the charge will be 5.000 % of my overdue payment of Principal and Interest. I will pay this late charge promptly but only once on each late payment.

Initials: [redacted]

(B) Default
If I do not pay the full amount of each monthly payment on the date it is due, I will be in default.

(C) Notice of Default
If I am in default, the Note Holder may send me a written notice telling me that if I do not pay the overdue amount by a certain date, the Note Holder may require me to pay immediately the full amount of Principal that has not been paid and all the interest that I owe on that amount. The date must be at least 30 days after the date on which the notice is mailed to me or delivered by other means.

(D) No Waiver By Note Holder
Even if, at a time when I am in default, the Note Holder does not require me to pay immediately in full as described above, the Note Holder will still have the right to do so if I am in default at a later time.

(E) Payment of Note Holder's Costs and Expenses
If the Note Holder has required me to pay immediately in full as described above, the Note Holder will have the right to be paid back by me for all of its costs and expenses in enforcing this Note to the extent not prohibited by applicable law. These expenses include, for example, reasonable attorneys' fees.

8. GIVING OF NOTICES
Unless applicable law requires a different method, any notice that must be given to me under this Note will be given by delivering it or by mailing it by first class mail to me at the Property Address above or at a different address if I give the Note Holder a notice of my different address.

Unless the Note Holder requires a different method, any notice that must be given to the Note Holder under this Note will be given by delivering it or by mailing it by first class mail to the Note Holder at the address stated in Section 3(A) above or at a different address if I am given a notice of that different address.

9. OBLIGATIONS OF PERSONS UNDER THIS NOTE
If more than one person signs this Note, each person is fully and personally obligated to keep all the promises made in this Note, including the promise to pay the full amount owed. Any person who is a guarantor, surety or endorser of this Note is also obligated to do these things. Any person who takes over these obligations, including the obligations of a guarantor, surety or endorser of this Note, is also obligated to keep all the promises made in this Note. The Note Holder may enforce its rights under this Note against each person individually or against all of us together. This means that any one of us may be required to pay all the amounts owed under this Note.

10. WAIVERS
I and any other person who has obligations under this Note waive the rights of Presentment and Notice of Dishonor. "Presentment" means the right to require the Note Holder to demand payment of amounts due. "Notice of Dishonor" means the right to require the Note Holder to give notice to other persons that amounts due have not been paid.

11. SECURED NOTE
In addition to the protections given to the Note Holder under this Note, a Mortgage, Deed of Trust, or Security Deed (the "Security Instrument"), dated the same date as this Note, protects the Note Holder from possible losses that might result if I do not keep the promises that I make in this Note. That Security Instrument describes how and under what conditions I may be required to make immediate payment in full of all amounts I owe under this Note. Some of these conditions are described as follows:

> **Transfer of the Property or a Beneficial Interest in Borrower.** As used in this Section 18, "Interest in the Property" means any legal or beneficial interest in the Property, including, but not limited to, those beneficial interests transferred in a bond for deed, contract for deed, installment sales contract or escrow agreement, the intent of which is the transfer of title by Borrower at a future date to a purchaser.
>
> If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument. However, this option

shall not be exercised by Lender if such exercise is prohibited by Applicable Law. Lender also shall not exercise this option if: (a) Borrower causes to be submitted to Lender information required by Lender to evaluate the intended transferee as if a new loan were being made to the transferee; and (b) Lender reasonably determines that Lender's security will not be impaired by the loan assumption and that the risk of a breach of any covenant or agreement in this Security Instrument is acceptable to Lender.

To the extent permitted by Applicable Law, Lender may charge a reasonable fee as a condition to Lender's consent to the loan assumption. Lender may also require the transferee to sign an assumption agreement that is acceptable to Lender and that obligates the transferee to keep all the promises and agreements made in the Note and in this Security Instrument. Borrower will continue to be obligated under the Note and this Security Instrument unless Lender releases Borrower in writing.

If Lender exercises the option to require immediate payment in full, Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is given in accordance with Section 15 within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

WITNESS THE HAND(S) AND SEAL(S) OF THE UNDERSIGNED.

[redacted] (Seal) -Borrower

(Seal) -Borrower

(Seal) -Borrower

(Seal) -Borrower

(Seal) -Borrower

(Seal) -Borrower

(Seal) -Borrower

(Seal) -Borrower

Pay to the order of:

Without Recourse
[redacted], Inc.

By: _____
Name: Jennifer Bruder
Its: Assistant Secretary

[redacted]00072

APPENDIX II

Chevy Chase F.S.B.
Wholesale Lending Division
Loan Origination Guidelines

PROPERTY REQUIREMENTS:

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

UNDERWRITING:

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

Employment/Income Source	Acceptable Verification Sources
Salaried	Verbal VOE
Self-Employed	Business existence must be documented for all self-employed applicants through: • evidence of a business license; and • verbal confirmation of a phone directory listing. A signed confirmation of the business must be obtained from the applicant's accountant where a license is not required for the business.
Retirement **Social Security** **Annuity** **Trust**	▪ Awards Letter with income "blacked out"; **or** ▪ Verify annuity funds; **or** ▪ Letter from Trustee
Schedule B **Dividend & Interest** **Income**	▪ Verify assets supporting income; **or** ▪ Sch. B with income "blacked out"

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

- Refer to the "Loan Limits" section for the minimum credit score requirement.
- Applicants without credit scores are not eligible.
- Cash reserves are not required.
- Non-permanent resident aliens are acceptable per Fannie Mae guidelines.
- First-time homebuyers are eligible.
- Non-occupant co-borrowers are not acceptable.
- Second homes or investment properties – applicants may not own more than five (5) financed properties, including their primary residence.
- Special Feature Code (SFC): 442

APPENDIX III

IndymacBank Conditional Approval Notice

IndymacBank

Conditional Approval Notice

Date: January 11, 2006	IndyMac Loan Number: 122675401 Rate Lock Number: Exception Number:	Credit Report Expiration: ** 3/21/2006 Conditional Approval Expiration: 1/18/2006 Ratelock Expiration:
To: Global Financial Inc ATTN: Dana Russell Seller Phone: (516) 791-3232 Ext: 122 Seller Fax: (516) 977-8996		IndyMac Review Date: Jan 9, 2006
Seller Number: 19880	Seller Loan Number: FergusonS	

TERMS

Note Rate:	1.250% Not Locked	Loan Amount:	445,000.00	Loan Product:	12 MAT B
Prepay Penalty Type:	3 Years	Sub. Lien:		Occupancy:	Primary Residence
ARM Margin:	3.250%	Appraised Value:	740,000.00	MI Coverage Level:	
Loan Priced with Impounds?:	Yes	Sales Price:		Lien Position:	1st
Construction Period (if applicable) :		LTV:	60.14	Decision Credit Score:	666
Purpose:	Cash Out	CLTV:	60.14		
Documentation:	No Income No Asset	Debt Ratios:	0.00 / 00.00		
Property Type:	2 Unit / Duplex	Reserves :	0.00 Month(s)		

The following conditions must be received by the Conditional Approval Expiration Date shown above or the loan will be subject to cancellation by IndyMac Bank, F.S. B.

All conditions must be sent/faxed together at one time. Conditions sent individually will not be reviewed until all conditions are received. A copy of this Conditional Approval Notice must be included with the conditions as the cover sheet. Please handwrite the IndyMac Bank loan number and condition number on each page of the conditions being sent.

Direct General Inquiries to:	
Customer Advocacy Group: (800) 601-4961	**Processing Center: Mt.Laurel** **Mailing Address:**
Business Development Manager : William Carmack (516) 692-0340 Ext:	IndyMac Bank, B2B Lending Operations 303 Lippincott Dr, 3rd Floor
Customer Account Manager : Meredith Ewen (800) 300-9266 Ext: 3482	Marlton, NJ 08053

Prior To Doc

Contact: Randi Dubois
Send Conditions to Processing Center Fax: (626) 440-7533 or via Email to: B2B_NJ_UW@Indymacbank.com****

e-MITS Prior-to-Doc: External

#	Condition	Condition Comment	Received Date
32	MISCELLANEOUS #904: Awaiting e-MITS Data Correction. Following our review of this credit package, required data corrections were attempted but resulted in a "requested parameters not available" response from e-MITS. We have attempted to contact the Seller to review these. The Seller is advised to contact the underwriter to discuss alternatives. The necessary data corrections are as follows:	emits is currently down. the loan will be run in emits once all conditions are received. add'l conditions may apply	

e-MITS Prior-to-Doc: Internal

#	Condition	Condition Comment	Received Date
21	PTD #126: IndyMac in-house appraisal review and approval required. Additional conditions may follow.		Jan 9 2006 9:49AM
1	PTD #240 - Internal Condition: This loan is subject to reverification of employment/income. Please note that additional conditions may be issued as a result of this reverification.		

Prior To Doc - e-MITS Conditions

Contact: Randi Dubois
Send Conditions to Processing Center Fax: (626) 440-7533 or via Email to: B2B_NJ_UW@Indymacbank.com****

Loan Application

#	Condition	Condition Comment	Received Date
4	Completed typed 1003 Application (rev. 01/04) with no reference to income or assets. The file must not contain any documents that reference income or assets.	borrower to provide employment info, name, address and phone number. no income	
5	Completed initial 1003 Application (rev. 01/04) signed by all borrowers with no reference to income or assets.	borrower to provide employment info, name, address and phone number. no income	

Employment/Income

#	Condition	Condition Comment	Received Date

APPENDIX IV

Loan Agreement,
Beneficial Homeowner Service

[redacted]

LOAN AGREEMENT
Including Truth-in-Lending Disclosure

Lender: (Called "We", "Us", "Our") BENEFICIAL HOMEOWNER SERVICE CORPORATION 3225 E LAKE ROAD ROSELAND CTR-SUITE G CANANDAIGUA, NY 14424
Borrowers: (Called "You", "Your") [redacted]
Date of Loan: 12/16/2005 — **Loan Numbe**[redacted]

In this agreement, "you", "your" mean the Borrower(s) who signs this agreement. "We", "us" and "our" refer to the Lender. This agreement covers the terms and conditions of your loan. It is important to us that you clearly understand the features of your loan. Please read this agreement carefully, and ask us any questions you may have.

Truth-in-Lending Disclosure

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate.	FINANCE CHARGE The dollar amount the credit will cost you.	Amount Financed The amount of credit provided to you or on your behalf.	Total of Payments The amount you will have paid after you have made all payments as scheduled.
7.707%	$154,203.03 ("e")	$130,899.45	$285,102.48 ("e")

Your payment schedule will be:

Number of Payments	Amount of Payments	When Payments are Due ("e")
1	$1,125.78	Day 16 of each month thereafter.
11	$1,125.78	Day 16 of each month thereafter.
12	$1,099.33	Day 16 of each month thereafter.
12	$1,073.76	Day 16 of each month thereafter.
12	$1,049.12	Day 16 of each month thereafter.
12	$1,025.44	Day 16 of each month thereafter.
12	$1,002.74	Day 16 of each month thereafter.

[redacted]

12	$981.08	Day 16 of each month thereafter.
12	$960.47	Day 16 of each month thereafter.
12	$940.93	Day 16 of each month thereafter.
12	$922.49	Day 16 of each month thereafter.
180	$905.16	Day 16 of each month thereafter.
"e" means an estimate		

YOU ARE GIVING US A SECURITY INTEREST IN THE REAL PROPERTY AS DESCRIBED IN THE MORTGAGE AND LOCATED AT:

[redacted]

Prepayment You may prepay your loan in full or in part at any time. If you pay off your loan early, you may have to pay a penalty and you will not be entitled to a refund of that part of the Finance Charge consisting of any prepaid finance charges.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

The Settlement Statement provides your disbursements and the itemization of the Amount Financed.

The figure disclosed in the Annual Percentage Rate box on page one is a composite Annual Percentage Rate which reflects the effect of the various interest rate reductions over the term of your loan. Your payment schedule assumes that all payments are received on the due date. See the "Adjustment to Contract Rate (Pay Right Rewards Program)" section of this agreement.

ABOUT THE SECURITY:

Your Obligation to Insure You shall keep the structures located on the real property securing your loan insured against damage caused by fire and other physical hazards, name us as a loss payee and deliver to us a loss payable endorsement. If insurance covering the real property is canceled or expires while your loan is outstanding and you do not reinstate the coverage, we may obtain, at our option, hazard insurance coverage protecting our interest in the real property as outlined below.

Real Property Taxes and Homeowners Insurance Homeowners Insurance covering fire and other hazards on the real property security is required, naming us as a loss payee for the term of your loan. You shall pay us on the day that monthly installments are due under this agreement, an additional sum (the "Funds") to be used to provide for payment of amounts due for: (a) taxes and

[redacted]

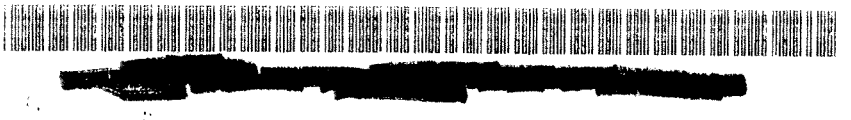
assessments and other items which can attain priority over the Mortgage as a lien or encumbrance on the real property; (b) leasehold payments or ground rents on the real property, if any; (c) premiums for any and all insurance required by us under this agreement and the Mortgage ("Escrow Items"). You will pay us the Funds for Escrow Items unless we waive your obligation to pay the Funds for any or all Escrow Items. We may waive your obligation to pay us Funds for any or all Escrow Items at any time. Any such waiver must be in writing. In the event of such waiver, you will be solely responsible for paying the amounts due for any Escrow Items directly and, if we require, you shall furnish us with receipts evidencing such payment within such time period as we may reasonably require.

Title Insurance

Title insurance on the real property security is required, naming us as a loss payee. You must purchase title insurance or its local equivalent protecting our lien on the real property as a condition to obtaining your loan. You may purchase title insurance from any title insurance provider you choose that we reasonably believe provides sufficient financial protection to us. You request such title insurance and authorize us to deduct the costs of the title insurance from your loan proceeds in order to pay the title insurance provider.

Lender's Right to Place Hazard Insurance

You authorize us, at our option, to obtain hazard insurance coverage on the real property in an amount not greater than the outstanding balance of principal and interest on your loan or, if known to be less, the replacement value of the real property, in the event that you fail to maintain the required hazard insurance outlined above or fail to provide adequate proof of its existence. You authorize us to charge you for the costs of this insurance. We may choose to add the insurance charges to the unpaid balance of your loan, which will accrue interest at the Contract Rate, or bill you for the annual premium on a periodic basis. The addition of the insurance charges due might increase the amount of your final monthly installment. The cost of lender-placed hazard insurance might be higher than the cost of standard insurance protecting the real property. The lender-placed insurance will not insure the contents of the real property or provide liability coverage. The insurance might not be the lowest cost coverage of its type available and you agree that we have no obligation to obtain the lowest cost coverage. We or an affiliated company might receive some benefit from the placement of this insurance and you will be charged for the full cost of the premium without reduction for any such benefit. If at any time after we have obtained this insurance, you provide adequate proof that you have subsequently purchased the required coverage, we will cancel the coverage we obtained and credit any unearned premiums to your loan.



ABOUT YOUR LOAN REPAYMENT:

SCHEDULED MATURITY DATE	12/16/2030	PREPAID FINANCE CHARGES	$134.53
MONTHS OF CONTRACT	300	PRINCIPAL	$131,033.98
CONTRACT RATE (per year)	9.290%		
AMOUNT FINANCED	$130,899.45		

Promise to Pay

You agree to the terms of this agreement and promise to pay us the principal (Amount Financed plus prepaid finance charges consisting of Origination Fee/Points) plus interest which is computed at a rate of 9.290% (the "Contract Rate"). You agree to pay us in monthly installments as stated in the Payments provision of this agreement. You also agree to pay us: (a) other charges as provided in this agreement; (b) credit insurance charges, if any; (c) collection costs permitted by applicable law, including reasonable attorneys' fees otherwise due under your Mortgage and (d) any other charges reflected in your settlement statement.

Interest

Interest will be charged on the unpaid principal until the full amount of principal has been paid. You will pay us interest at a yearly Contract Rate of 9.290%.

The interest rate you will pay will change in accordance with the "Adjustment to Contract Rate (Pay Right Rewards Program)" section of this agreement.

The interest rate required by this provision (and the Adjustment to Contract Rate [Pay Right Rewards Program] provision of this agreement) is the rate you will pay both before and after any default as described in this agreement.

After the Scheduled Maturity Date, you will pay interest at the contract rate in effect as of the Scheduled Maturity Date.

Payments

Time and Place of Payments

You will pay us principal and interest by paying your monthly installments.

You will make your monthly installments to us on the same day of each month beginning on or about 01/16/2006. You will make these monthly installments every month until you have paid all of the principal and interest and any other charges described herein that you may owe under this agreement. Your monthly installments will be applied to interest before principal. If, on the Scheduled Maturity Date, 12/16/2030, you still owe amounts under this agreement, you will pay those amounts in full on that date, which amount will include interest at the then current Contract Rate or any such other rate as required by law.

You will make your monthly installments at the address shown on page one or at the address shown on your monthly billing statement or at a different place that we may give you.

Amount of Monthly Installments

Your initial monthly installment will be in the amount of $1,125.78, plus the amount of any optional insurance you elected. Your monthly installment amount will change if the interest rate that you must pay changes. We will determine your new interest rate and the changed amount of your monthly installment in accordance with the Adjustment to Contract Rate (Pay Right Rewards Program) provision of this agreement.

Adjustment to Contract Rate (Pay Right Rewards Program)

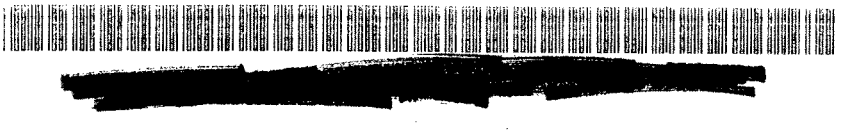
The Contract Rate of 9.290% will decrease by 0.30% beginning with the thirteenth (13th) month after every twelve (12) consecutive monthly periods where all monthly installments were made in full within 30 days of their due date. Up to a maximum of 10 Contract Rate reductions are available during the term of your loan. For each Contract Rate reduction, the monthly installment will be reduced accordingly. Notwithstanding anything to the contrary in this paragraph, you will not receive any Contract Rate reductions or the reduced monthly installment after 24 periods of delinquency. A "period of delinquency" is defined as any monthly installment that is received more than 30 days past its due date. Consecutive monthly installments received more than 30 days past their respective due dates each count as separate periods of delinquency.

Prepayment

Subject to the prepayment penalty described below, you may prepay your loan in full or in part at any time. If you pay off your loan early, you may have to pay a penalty and you will not be entitled to a refund of that part of the Finance Charge consisting of any prepaid finance charges.

Prepayment Penalty

Your loan contains a prepayment penalty. If you prepay the entire outstanding balance of your loan at any time within 12 months of the Date of Loan, 12/16/2005, you agree to pay a prepayment penalty equal to 6 months interest calculated at the Contract Rate in effect at the time of prepayment on the unpaid principal balance. No prepayment penalty will be imposed: (a) if your loan is refinanced by another loan with us; (b) after 12 months; (c) if your loan is prepaid from the proceeds of any insurance; or (d) if we sue you.



Bad Check Charge	You agree to pay $20.00 each time any check or payment is made on your loan by any means, including but not limited to, a check or ACH (our Authorization to Debit Account), which is returned unpaid by your bank or other financial institution for any reason.You agree that we may deduct this charge from a monthly payment.
Additional Charges	You agree to pay any amounts actually incurred by us for services rendered in connection with the opening and servicing of your loan, as allowed by law. These amounts may include fees for appraisals, title examination, title insurance or its local equivalent, fees and taxes paid to public officials in connection with recording, releasing or satisfying the Mortgage and other taxes as shown in the Settlement Statement incorporated herein by this reference. You also agree to pay any other amounts incurred by us in connection with the servicing of your loan including any amounts that we may (but need not) pay or that are otherwise due under the Mortgage, incorporated herein by this reference.
Default	If you don't pay on time or fail to keep any required insurance in force, or if permitted in the event of default under the Mortgage, (1) all your payments may become due at once, and (2) without notifying you before bringing suit, we may sue you for the entire unpaid balance of Principal and accrued Interest and (3) any judgment in our favor may include our reasonable attorney's fee and court costs as determined by the court. You agree that, should we obtain judgment against you, a portion of your disposable earnings may be attached or garnished (paid to us by your employer), as provided by Federal law. You agree to pay interest on any judgment which has resulted from this Agreement at a rate of 9% per year until the judgment is paid in full.
Security Interest	You agree to give us a security interest in the real property as described in the Mortgage.

ABOUT OUR RELATIONSHIP:

Exchange of Information	You understand and agree that we will call you from time to time to discuss your financial needs and any loan products that may be of interest to you as may be permitted by applicable law. For more information regarding our privacy practices, please refer to our Privacy Statement, which is included with your loan documents. You agree that the Department of Motor Vehicles (or your state's equivalent of such department) may release your residence address to us, should it become necessary to locate you.
Credit Bureau Reporting	If you fail to fulfill the terms of your loan, a negative report reflecting on your credit record may be submitted to a Credit Reporting Agency.
Telephone Monitoring	You agree that we may listen to and/or record telephone calls between you and our representatives for quality assurance purposes.

Insurance	Credit insurance is optional. Any applicable insurance disclosures are included with this agreement and are incorporated herein by this reference.
Alternative Dispute Resolution	The terms of the Arbitration Rider signed by you as part of your loan transaction are incorporated herein by this reference.
Applicable Law	The terms and conditions of this agreement will be governed by the Mortgage Bankers Law (MBL), Article 12-D of the Banking Law of New York, and Part 80 of the Regulations of the New York Banking Board issued under the MBL. If this loan is a first mortgage, it is a federally related loan made at an agreed rate authorized by Section 501(a), Part A, Title V, Public Law 96-221, also known as Section 1735f-7(a), Title 12, United States Code.

If any provision of this agreement is finally determined to be void or unenforceable under any law, rule, or regulation, all other provisions of this agreement will remain valid and enforceable. Our failure to enforce any provision(s) to this agreement shall not be deemed to constitute a waiver of such term(s). In order for any amendment to this agreement to be valid, it must be agreed to by you and us.

You acknowledge that before signing this agreement, you have read and received this agreement which includes the Federal Truth-in-Lending disclosure and, as applicable, any other riders and/or disclosures incorporated herein by reference. By signing below, you agree to observe the terms and conditions of this agreement.

DEFAULT IN THE PAYMENT OF THIS LOAN AGREEMENT MAY RESULT IN THE LOSS OF THE PROPERTY SECURING THE LOAN. UNDER FEDERAL LAW, YOU MAY HAVE THE RIGHT TO CANCEL THIS AGREEMENT. IF YOU HAVE THIS RIGHT, THE CREDITOR IS REQUIRED TO PROVIDE YOU WITH A SEPARATE WRITTEN NOTICE SPECIFYING THE CIRCUMSTANCES AND TIMES UNDER WHICH YOU CAN EXERCISE THIS RIGHT.

Borrow[redacted] _____ Date: _____

Borrower: [redacted] _____ Date: _____

Witness: _____

[redacted]