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December 30, 2010

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Via e-mail (regs.comments@federalreserve.gov)

RE: Docket No. R-1366
Regulation Z (Truth in Lending)

Dear Ms. Johnson:

This comment letter is submitted in response to the recently published interim rule amending 12 CFR Section 226.18(s) (75 Fed. Reg. 81836 (December 29, 2010), compliance optional as to applications received before October 1, 2011). I submit these comments in my personal capacity only, and not on behalf of any client or colleague.

Please provide additional guidance concerning the following matters:

(1) "Preferred rate" transactions.

Additional clarification is needed concerning the required disclosure of the maximum possible interest rate and corresponding periodic loan payment that could potentially be effective in the first 5 years after the first required regular periodic payment due date, for certain "preferred rate" transactions. For example, suppose a consumer receives a 0.25% per year interest rate reduction for as long as the consumer agrees to have required periodic loan payments made automatically from the consumer's deposit account. Suppose further that this 0.25% per year interest rate reduction is part of the consumer's formal consumer credit obligation (formal loan contract). In theory, the consumer could close the deposit account and terminate the automatic loan payment arrangement the day after the loan is consummated, in which case the interest rate on the loan could potentially increase at that time by 0.25% per year (although the effect of that rate increase might not be seen until the consumer's second required regular periodic payment comes due, depending on the exact terms of the automatic loan payment rate reduction agreement between the consumer and the creditor).

The Official Staff Commentary to Section 226.18(s) indicates that creditors must assume the interest rate will increase as rapidly as possible, consistent with the terms of the consumer credit obligation. This would appear to require creditors to assume that consumers will discontinue their voluntary automatic loan repayment arrangements immediately after their loans have closed. In such cases, the earliest date on which consumers might lose the benefit of an automatic loan payment rate reduction could potentially be the first business day after loan consummation (or the first required regular periodic payment due date, depending on the specific terms of the automatic loan payment rate reduction agreement), although consumers may not have any present intent to terminate their automatic loan payment arrangements.

Similar issues arise with other types of "preferred rate" transactions (such as employee preferred rate transactions) if the preferred rate is part of the consumer's formal legal obligation (by being reflected in the promissory note or loan agreement, as opposed to an informal side agreement). Is the creditor required to assume that the consumer will lose "preferred rate" eligibility (perhaps because of a voluntary or involuntary employment termination) the day after the loan is consummated?

This issue affects adjustable rate mortgage loans, where the "preferred rate" effectively corresponds to a slightly lower (reduced) "margin" being added to an index value for rate adjustment purposes. This issue also affects nominally "fixed" interest rate transactions where the "fixed" interest rate is initially less than what it otherwise would have been, due to the consumer's eligibility for a preferred (lower) "fixed" interest rate as of loan closing, but where the fixed interest rate may increase to the "regular" or normal fixed interest rate if the consumer loses eligibility for the preferred fixed interest rate after the loan has closed.

Pursuant to HUD's RESPA regulations, creditors should disclose the date on which a "preferred" rate may expire (if expiration is due to such things as the consumer no longer having automatic loan payments, or no longer being employed by the creditor) as "*unknown*" on the good faith estimate and HUD-1 settlement statement. (See HUD RESPA FAQs, updated April 2, 2010: "If the first interest rate change date is not known due to a conditional preferred rate feature, the first change date box should state 'unknown.'") However, disclosing the effective date of a rate increase as "unknown" in the Section 226.18(s) table could be confusing to a consumer, since the creditor must implicitly assume a specific date for the hypothetical rate increase in order to calculate and disclose a corresponding periodic loan payment amount associated with that rate increase.

For somewhat greater consistency with the consumer's RESPA-required disclosures, the Federal Reserve Board (the "Board") should allow creditors (at their option) to disclose the date on which a consumer's eligibility for the "preferred" (reduced) interest rate (and margin, if applicable) expires as "unknown" (if this is accurate) for purposes of the Section 226.18(s) disclosures, with a short explanation (which may be located <u>outside</u> the Section 226.18(s) table) concerning the consumer's potential loss of the "preferred" rate (or, more precisely, potential loss of the interest rate and/or margin reduction associated with the consumer's "preferred" rate status). Creditors electing this disclosure option also should be excused from having to calculate and disclose the consumer's hypothetical periodic loan payment amount(s) at the higher, non-preferential interest rate and/or margin within the Section 226.18(s) table.

Consistent with the above-suggested approach for Section 226.18(s), the consumer's disclosed "Total of Payments" (and other related disclosures) also should not have to reflect the possibility that the consumer might lose eligibility for the "preferred" (reduced) interest rate and/or margin at some unknown time post-closing.

(2) <u>Additional examples of variable rate loans with initial interest-only payments</u>.

The Official Staff Commentary to Section 226.18(s)(2)(i)(C) includes an example of a variable rate loan with initial interest-only payments that are scheduled to convert to principal and interest payments before the first interest rate adjustment date, not on or after an interest rate adjustment date. Guidance concerning how to disclose a scheduled shift from interest-only periodic loan payments to principal and interest periodic loan payments, when that shift is scheduled to occur after the interest rate potentially has already reached its "worst case" maximum, would be useful. For example, suppose a loan with scheduled annual rate adjustments could reach its maximum possible interest rate as early as the scheduled payment due date for the 60th or the 72nd monthly payment (under a "worst case" scenario). Suppose, however, that the first 120 scheduled monthly payments are interest-only, with amortizing payments of principal and interest due beginning with the 121st monthly payment. Even if the interest rate did not adjust at the end of the 10th year of the loan (in this hypothetical example), perhaps because the loan was already at its maximum possible interest rate at that time, or because the index on which annual rate adjustments are based had not changed since the last rate adjustment, the scheduled periodic loan payment in this example would increase because of the scheduled switch from interest-only payments to principal and interest payments. (Such a scheduled increase to the periodic loan payment amount likely would occur even if the interest rate decreased due to a decrease to the related index value – it is unlikely a rate decrease would completely counterbalance the principal amount scheduled to be added to the periodic loan payment.) In such a case, it is unclear from the wording of Section 226.18(s)(2)(i)(C) whether the column labeled "Maximum Ever" could (or should) precede a column labeled "First Adjustment", or whether the column labeled "Maximum Ever" should be reserved for disclosing the earliest date on which the "worst case" (highest) periodic loan payment of principal and interest might come due (in which case a separate column would be needed to show when the "worst case" or highest periodic interest-only payment might come due)?

(3) "Material" payment schedule disclosures under 12 CFR Section 226.23.

Section 226.23 presently defines "material disclosures" for closed-end rescission purposes to include (among other things) "the payment schedule." Prior to the effective date of Section 226.18(s), this reference to the "payment schedule" was to Section 226.18(g) disclosures, which did not include any "worst case" assumptions and also did not need to include any information about escrow payments for property taxes or property insurance. Upon the effective date of Section 226.18(s), it is unclear to what extent an error in a Section 226.18(s) disclosure would constitute a failure to provide a "material disclosure" for closed-end rescission purposes.

15 USC Section 1602 defines the "material disclosures" for rescission purposes. Payment schedule "material disclosures" include "the number and amount of payments" and "the due dates or periods of payments scheduled to repay the indebtedness." Thus, minor and technical matters, such as column headings, other tabular formatting issues, font size, the placement or position of the balloon payment disclosure described in Section 226.18(s)(5),[1] and similar matters, should not be relevant to whether the "material" aspects of the consumer's payment schedule have been disclosed. For example, a consumer's extended (3-year) right to rescind should not depend on such things as whether a

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[1] There is a little confusion about the proper placement of the balloon payment disclosure. The Supplementary Information preceding the original interim rule (see 75 Fed. Reg. 58478 (second column), discussing Section 226.18(s)(5)) states that the balloon payment "must be disclosed *in the last row of the table* rather than in a column, unless it coincides with an interest rate adjustment or other payment increase such as the expiration of an interest-only option." (emphasis added) This conflicts with Section 226.18(s)(5)(i), which states the general rule that a balloon payment be disclosed "outside the table." There is also some confusion over when the special rule in Section 226.18(s)(5)(ii) should apply, since a balloon payment is by definition a loan payment that will be higher than other preceding regular periodic loan payments even if there is no interest rate adjustment.

professional typesetter is willing to testify in open court as to whether the consumer's Section 226.18(s) disclosures were in a minimum of 10-point font, or whether an appropriate expert is willing to testify as to whether the consumer's Section 226.18(s) disclosures were placed in a sufficiently prominent location.

Here are additional (non-exclusive) examples of matters that should not be considered "material" for closed-end rescission purposes:

- Errors in estimated escrow payment amounts. (Escrow payment amounts are clearly disclosed as estimates under Section 226.18(s). Residential mortgage borrowers with escrow accounts for property taxes and/or property insurance also should be receiving RESPA-required escrow account statements periodically post-closing.)
- Specifics about the variable rate feature of the transaction (if applicable), such as "worst case" examples and lifetime interest rate ceilings.
- Failure to give the disclosure described in Section 226.18(s)(2)(iii) (or any error in such a disclosure).

Examples of Section 226.18(s) disclosures that could potentially be considered "material" for closed-end rescission purposes might include the following:

- The dollar amount of the initial (first) required periodic payment of principal and/or interest (subject to a reasonable disclosure tolerance, as discussed more fully in Section (4) of this letter, below).
- Disclosure of the fact (if applicable) that the minimum periodic payment will cause the principal loan amount to increase.
- Disclosure of the fact (if applicable) that the transaction requires a balloon payment.
- Disclosure of the fact (if applicable) that the transaction has a variable rate feature.

This "material disclosure" rescission issue overlaps with the Board's proposed revisions to Regulation Z as set forth in **Docket No. R-1390** (public comments accepted until December 23, 2010) and the original version of Docket No. R-1366 (published in the August 26, 2009 Federal Register). In Docket No. R-1390, the Board expressed its view (based in part on consumer survey data) that not all of the information required to be disclosed under Section 226.18(g) (or in the Board's proposed new Section 226.38) should be considered "material" for closed-end rescission purposes. However, until the rulemaking in Docket No. R-1390 is finalized, this "material disclosure" issue with respect to the "payment schedule" disclosures required by Section 226.18(s) should be specifically addressed and clarified as part of the Board's current rulemaking (Docket No. R-1366).

(4) Disclosure tolerances.

Section 226.18(s) should include tolerances for certain required disclosures. For example, disclosure of interest rates should be subject to a reasonable disclosure tolerance, to allow for such things as rounding or truncating of certain digits to the right of the decimal point. (By way of rough analogy, 12 CFR Section 230.3(f)(1) allows rounding of the interest rate applicable to an interest-bearing consumer deposit account to the nearest one-hundredth of a percentage point.)

As another example of a reasonable and appropriate disclosure tolerance, in Docket No. R-1390, the Board proposed that, for purposes of the "material disclosure" requirement in Section 226.23, a periodic loan payment amount that was either overdisclosed (by any amount) or underdisclosed by no more than $100, should be considered accurate for purposes of Section 226.23 (subject to a special tolerance rule for HOEPA loans). This disclosure tolerance should be added to Section 226.18(s) and/or Section 226.23 as part of the Board's current rulemaking (Docket No. R-1366).

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I thank you very much for the opportunity to present these comments. Please do not hesitate to contact me at (203) 776-1911 during regular business hours (Eastern Time) if you have any questions about any of the matters discussed in this letter or would like any further information.

Sincerely,
/s/ *Elizabeth C. Yen*
Elizabeth C. Yen