BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

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DATE: December 12, 2007

TO: Board of Governors

FROM: Governor Kroszner
Committee on Consumer and Community Affairs

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

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

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FROM: Division of Consumer and Community Affairs *

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

**ACTION REQUESTED:** Approval to publish proposed amendments to Regulation Z (Truth in Lending) for public comment. The amendments would prohibit certain acts and practices in connection with closed-end mortgage loans, particularly higher-priced mortgage loans; revise the disclosure requirements for mortgage advertisements; and revise the timing requirements for providing disclosures for closed-end mortgages.

**Summary**

Under the Home Ownership and Equity Protection Act (HOEPA), which amended the Truth in Lending Act (TILA), the Board is authorized to prohibit acts and practices in connection with mortgage lending that the Board finds to be unfair, deceptive, or designed to evade HOEPA and, with respect to mortgage refinancings, associated with abusive lending practices, or otherwise not in the interest of the borrower. The proposed amendments to Regulation Z would rely upon this authority, along with the Board's general rulemaking authority, to achieve three goals: (1) prohibit certain acts or practices for higher-priced mortgage loans and prohibit other acts or practices for closed-end credit transactions secured by a consumer's principal dwelling; (2) revise the disclosures required in advertisements for credit secured by a consumer's dwelling and prohibit certain practices in connection with closed-end mortgage advertising; and (3) require disclosures for closed-end mortgages to be provided earlier in the transaction.

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The proposed amendments cover four broad areas. First, staff <u>recommends</u> amending Regulation Z with regard to higher-priced mortgage loans that are secured by a consumer's principal dwelling to prohibit creditors from: (1) engaging in a pattern or practice of extending credit based on the collateral without regard to consumers' ability to repay; (2) making a loan without verifying the income and assets relied upon to make the loan; (3) imposing prepayment penalties in certain circumstances; and (4) making loans without establishing escrows for taxes and insurance. In addition, the proposal would prohibit creditors from structuring loans as open-end lines of credit to evade the new protections. As discussed in detail beginning on page 16, the term "higher-priced mortgage loans" would be defined as closed-end consumer credit transactions secured by the consumer's principal dwelling where the annual percentage rate (APR) on the loan exceeds the yield on comparable Treasury securities by at least three percentage points for first-lien loans, or five percentage points for subordinate-lien loans. A summary of the specific staff recommendations regarding higher-priced mortgages follows:

- <u>Ability to Pay</u>. The proposal would extend and apply to higher-priced mortgage loans secured by a consumer's principal dwelling the prohibition in TILA and Regulation Z against engaging in a pattern or practice of extending credit based on the collateral without regard to consumers' repayment ability that currently applies only to HOEPA-covered loans, which are the highest-cost loans in the market. The proposal would also create certain rebuttable presumptions about when a creditor has violated the rule and engaged in a prohibited pattern or practice. The proposed revisions are discussed in detail beginning on page 17.

- <u>Verification of Income and Assets</u>. The proposal would prohibit creditors, in extending credit for a higher-priced mortgage secured by a consumer's principal dwelling, from relying on amounts of income (including expected income) or assets, unless the creditor verifies such amounts by third-party documents that provide reasonably reliable evidence of the consumer's income and assets. The proposal would also create a safe harbor for creditors who fail to verify income or assets before extending credit, in cases where the consumer's income or assets upon which the creditor relied were not materially greater than what the creditor could have verified at closing. The proposed revisions are discussed in detail beginning on page 20.

- Prepayment Penalties. The proposal would extend and apply to higher-priced mortgage loans secured by a consumer's principal dwelling the restrictions on prepayment penalties in TILA and Regulation Z that currently apply only to HOEPA-covered loans. The proposal would also require that the period during which a prepayment penalty may be imposed must expire at least sixty days prior to the first date, if any, on which the principal or interest payment may increase under the terms of the loan. The proposed revisions are discussed in detail beginning on page 22.

- Escrows. The proposal would prohibit a creditor from making a higher-priced loan secured by a first-lien on a consumer's principal dwelling without establishing an escrow account for property taxes and homeowners' insurance. A creditor would be permitted, but not required, to offer the borrower the opportunity to cancel or "opt out" of the escrow twelve months after consummation. The proposed revisions are discussed in detail beginning on page 25.

Second, staff recommends amending Regulation Z with regard to closed-end credit transactions secured by a consumer's principal dwelling to prohibit: (1) creditors from paying mortgage brokers, unless certain disclosures have been provided by the broker in a timely fashion to the consumer; (2) creditors or mortgage brokers from coercing appraisers to misrepresent the value of a dwelling; and (3) loan servicers from engaging in certain unfair loan servicing practices. A summary of the specific staff recommendations follows:

- Yield Spread Premiums (Mortgage Broker Compensation). The proposal generally would prohibit creditors from directly or indirectly paying mortgage brokers in connection with consumer credit transactions secured by a consumer's principal dwelling, unless the mortgage broker enters into a written agreement with the consumer that includes certain disclosures, such as the total dollar amount of compensation that the broker will receive and retain from all sources. The rule would not prohibit creditor payments to brokers when the compensation is not determined, in whole or in part, by reference to the transaction's interest rate, or where state statutes or regulations impose comparable protections for consumers. The proposed revisions are discussed in detail beginning on page 28.

- <u>Coercion of Appraisers</u>. The proposal would prohibit a creditor or mortgage broker from coercing, influencing, or encouraging an appraiser to misrepresent the value of a consumer's principal dwelling. The proposal also would prohibit creditors from extending credit when a creditor knows or has reason to know that a person has coerced, influenced, or encouraged an appraiser to misstate the value of a consumer's principal dwelling, unless the creditor acts with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of such dwelling. The proposed revisions are discussed in detail beginning on page 32.

- <u>Loan Servicing</u>. The proposal would prohibit certain practices by servicers in connection with consumer credit transactions secured by a consumer's principal dwelling. For example, the proposal generally would prohibit a servicer from failing to credit a payment to the consumer's account as of the date of receipt or failing to provide a payoff statement within a reasonable period of time after the request. The proposal would also prohibit the practice of "pyramiding" late fees. The proposed revisions are discussed in detail beginning on page 33.

Third, staff <u>recommends</u> amending Regulation Z to revise the advertising rules for credit secured by a consumer's dwelling so that consumers receive accurate and balanced information. A summary of the specific staff recommendations follows:

- <u>Prohibited Advertising Practices</u>. The proposal would prohibit seven misleading or deceptive practices in advertisements for closed-end mortgages. For example, the proposal would prohibit use of the term "fixed" in a misleading manner in advertisements where the rate or payment is not fixed for the full term of the loan.

- <u>Advertising Disclosures</u>. The proposal would require that advertisements state all applicable rates or payments with equal prominence and in close proximity to any advertised introductory or "teaser" rate or payment. The proposal would also prohibit any advertisement for closed-end credit from stating an interest rate lower than the rate at which interest is accruing. The proposed advertising revisions are discussed in detail beginning on page 36.

Fourth, staff <u>recommends</u> amending Regulation Z to require creditors to provide early disclosures to consumers in both purchase money and non-purchase money mortgage closed-end credit transactions. The current rule requires early disclosures only in connection with purchase money mortgage transactions. The proposal would also prohibit a creditor or other person from imposing a fee on the consumer in connection with the consumer's application for a closed-end mortgage transaction (other than a reasonable fee to obtain a credit report or other credit history) until after the consumer has received the early disclosures. The proposed revisions are discussed in detail beginning on page 39.

**Background**

<u>Recent Problems in the Mortgage Market</u>

The mortgage market is often characterized as having three segments: the prime market; the subprime market; and the near-prime or alt-A market. In the prime market, competitive, widely-quoted rates and other terms are offered to consumers believed to pose a low credit risk. In the subprime market, consumers believed to pose a higher credit risk may obtain mortgages at rates and on terms less favorable than the rates and terms available in the prime market. The near-prime or alt-A market falls between the prime and subprime markets.

In recent years, a substantial majority of subprime mortgage loans have been adjustable rate mortgages (ARMs) with two or three-year introductory "teaser" rates that are followed by substantial increases in the rate and payment. Within the last two years, delinquencies for such mortgages have increased dramatically and reached exceptionally high levels. The delinquency rate for subprime mortgages may rise further as the rates on large numbers of subprime ARMs reset at significantly higher levels. The delinquency rate has also increased for near-prime or alt-A loans, but not as dramatically as it has for subprime mortgages. Consumers who default on home mortgage obligations face potentially severe consequences, including foreclosure and loss of the home, loss of accumulated home equity, higher rates for other credit, and reduced access to credit.

In addition to the general decline in real estate values, a loosening of underwriting standards has contributed to the recent increase in subprime mortgage delinquencies. A loosening of underwriting standards is particularly evident in the subprime mortgage market where insufficient regard to repayment ability, the lack of income verification, and high loan-to-value ratios combine to increase the risk of default. Looser underwriting standards have not been limited to the subprime market, but have also occurred in the alt-A market where risk layering on nontraditional mortgages, such as interest-only mortgages and payment-option ARMs, has been common.

Structural factors in the subprime market appear to warrant regulatory intervention to prevent injury to consumers. The role that these structural factors may play in increasing the likelihood of injury to consumers has been highlighted by the recent increase in delinquencies among subprime mortgages.

First, there is limited transparency in the subprime mortgage market, which makes it harder for consumers to protect themselves from abusive or unaffordable loans. Price information for the subprime market is not widely and readily available to consumers. This may limit consumer shopping. Products in the subprime market, such as ARMs, tend to be complex. As a result, consumers may focus on a few key attributes, such as the initial interest rate and down payment, but not focus on other important attributes, such as subsequent rate or payment increases. In addition, the roles and incentives of originators are not clear to consumers. Consumers often believe, usually in error, that a mortgage broker is obligated to find the consumer the best and most suitable loan terms available.

Second, the current market structure in which most subprime loans are securitized and sold to investors gives originators an incentive to generate high loan sales volume, rather than to underwrite loans carefully to ensure loan quality. Fragmentation of the mortgage originator market makes it difficult for regulators and investors to monitor originator activities.

The market is responding to the current problems with subprime mortgages by tightening underwriting standards and through other actions. In addition, the Board and the other federal banking agencies have issued supervisory guidance recently to address concerns about the subprime mortgage market and the rapid growth of non-traditional mortgage products.[1] However, staff believes structural factors in the subprime mortgage market make it appropriate to consider regulations to help prevent a recurrence of these problems and to provide clear rules at a time of uncertainty so that responsible subprime mortgage lending can continue.

The Truth in Lending Act

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

[1] See Statement on Subprime Mortgage Lending, SR 07-12/CA 07-3 (July 24, 2007) (available at http://www.federalreserve.gov/boarddocs/srletters/2007/SR0712.htm); Interagency Guidance on Non-Traditional Mortgage Product Risks, SR 06-15/CA 06-12 (Oct. 10, 2006) (available at http://www.federalreserve.gov/boarddocs/srletters/2006/sr0615.htm).

avoid the uninformed use of credit. TILA's disclosure requirements differ depending on whether consumer credit is an open-end (revolving) plan or a closed-end (installment) loan. TILA also contains procedural and substantive protections for consumers.

Congress enacted HOEPA in 1994 as an amendment to TILA. HOEPA imposed additional substantive protections on certain high-cost mortgage transactions. HOEPA-covered loans are closed-end, non-purchase money mortgages secured by a consumer's principal dwelling (other than a reverse mortgage) where either: (a) the APR at consummation will exceed the yield on Treasury securities of comparable maturity by more than 8 percentage points for first-lien loans, or 10 percentage points for subordinate-lien loans; or (b) the total points and fees payable by the consumer at or before closing exceed the greater of 8 percent of the total loan amount, or $547 for 2007 (adjusted annually).

HOEPA also authorized the Board to prohibit acts or practices in connection with mortgage loans and the refinancing of mortgage loans. In addition, HOEPA directed the Board to monitor through regular public hearings changes in the home equity market that might require the Board to prohibit acts or practices.

TILA is implemented by the Board's Regulation Z. An Official Staff Commentary interprets the requirements of Regulation Z. By statute, creditors that follow in good faith Board or official staff interpretations are insulated from civil liability, criminal penalties, or administrative sanction. Creditors face civil liability for engaging in acts or practices that the Board has prohibited under its HOEPA authority.

The Board's Rulemaking Authority

TILA Section 129(l)(2), added to the statute by HOEPA, provides the Board with the authority to prohibit acts or practices in connection with:

- Mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of HOEPA; and
- Refinancing of mortgage loans that the Board finds to be associated with abusive lending practices or that are otherwise not in the interest of the borrower.

HOEPA does not create a standard for what is unfair or deceptive, but the Congressional Conference Report for HOEPA indicates that the Board should look to the standards employed for interpreting state unfair or deceptive trade practices acts and the Federal Trade Commission Act.[2] Board staff has considered these standards in developing this proposal.

The Board's authority to prohibit unfair or deceptive acts or practices in connection with mortgage loans is broad and is not limited to mortgage loans currently covered by HOEPA. This authority allows the Board to prohibit acts or practices in connection with mortgage loans that do not meet the rate or fee triggers for HOEPA-covered loans, and in connection with home purchase loans, which are not covered by HOEPA. Moreover, the prohibitions adopted pursuant to this authority need not apply solely to creditors, nor be limited to the terms of mortgage loans. The prohibitions may apply to acts or practices by various parties "in connection with mortgage loans." Accordingly, the proposal would apply new prohibitions to a broader segment of the market than that which is currently covered by HOEPA's substantive protections. The Board's HOEPA rulemaking authority provides the legal basis for the prohibitions in

[2] H. Conf. Rep. 103-652, p. 162 (1994).

proposed sections 226.35 and 226.36, as well as the proposed prohibitions on misleading advertising practices.

In addition, TILA's general rulemaking authority specifically authorizes the Board, among other things, to do the following:

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

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

- Require disclosures in advertisements for closed-end credit and open-end credit plans.

The Board's general rulemaking authority under TILA provides the legal basis for the proposed revisions to Regulation Z regarding the timing of mortgage disclosures and advertising disclosures.

HOEPA Hearings

HOEPA requires the Board to hold a public hearing periodically to examine the home equity loan market and the adequacy of existing regulatory and legislative provisions in protecting consumers, particularly low-income consumers. In conducting hearings, the Board must solicit participation from consumers, representatives of consumers, lenders, and other interested parties. The Board held HOEPA hearings in 2000 and, as a result, made several changes to Regulations Z in 2002 dealing with mortgage loans covered by HOEPA. Generally, HOEPA covers very high cost mortgage loans that compose a small part of the mortgage market.

Summary of 2006 Hearings. In the summer of 2006, the Board held four HOEPA hearings across the country on three broad topics: (1) the impact of the 2002 HOEPA rule changes, and of state and local predatory lending laws, on predatory lending practices; (2) nontraditional mortgage products and reverse mortgages; and (3) informed consumer choice in the subprime market. Hearing panelists included mortgage lenders and brokers, credit ratings agencies, realtors, consumer advocates, community development groups, housing counselors, academicians, researchers, and state and federal government officials. In all, 67 individuals testified on panels and 54 comment letters were submitted to the Board.

Consumer advocates identified several areas of concern and urged the Board to take action to curb abusive practices for loans that do not meet HOEPA's price triggers. Consumer advocates urged the Board to prohibit or restrict certain loan features or terms, such as prepayment penalties, and underwriting practices, such as "stated income" or "low documentation" ("low doc") loans where the borrower's income is not documented or verified. They also expressed concern about aggressive marketing practices that include steering borrowers to higher-cost loans by emphasizing initial low monthly payments based on an introductory rate without adequately explaining that the consumer will owe considerably higher monthly payments after the introductory rate expires. Some consumer advocates also raised concerns about the lack of escrows for taxes and insurance in the subprime market. Finally, some consumer advocates stated that brokers and lenders should be held to a fiduciary standard of good faith and fair dealing or a requirement that they make only loans that are suitable for a particular borrower. These advocates also urged the Board to ban so-called "yield spread premiums," payments that brokers receive from the lender at closing for delivering a loan with an interest rate that is higher than the lowest rate for which the borrower could qualify, because such payments provide brokers an incentive to increase consumers' interest rates.

Most industry commenters opposed prohibitions on stated income loans, prepayment penalties, and other loan terms, asserting that these features could benefit some borrowers. They suggested that improved disclosures could address these issues and urged the Board and other regulators to focus instead on enforcing existing laws to remove "bad actors" from the market. Industry commenters also stated that subjective suitability standards would create uncertainties for brokers and lenders and subject them to litigation risk. Some lenders indicated, however, that carefully constructed restrictions on certain features or practices might be appropriate if the conditions were clear and would not unduly reduce credit availability.

<u>Summary of the June 2007 Hearing</u>. The Board held an additional hearing in June 2007 to explore how it could use its authority under HOEPA to prevent abusive lending practices in the subprime market while still preserving responsible subprime lending. The Board focused the hearing on four specific areas: lenders' determination of borrowers' repayment ability; "stated income" and "low doc" lending; the lack of escrows in the subprime market relative to the prime market; and the high frequency of prepayment penalties in the subprime market.

At the hearing, 16 witnesses testified including representatives of consumers, mortgage lenders, mortgage brokers, and state government officials, as well as academics.  The Board also received close to 100 written comments after the hearing from an equally diverse group of persons.

Industry representatives acknowledged concerns with recent lending practices but urged the Board to address most of these concerns through supervisory guidance rather than regulations under HOEPA.  They maintained that supervisory guidance provides the flexibility needed to preserve access to responsible credit.  They also suggested that the need for further intervention has been reduced by market self-correction as well as by the supervisory guidance issued by the Board and the other federal banking agencies recently regarding non-traditional mortgages and subprime lending.  They supported improving mortgage disclosures provided to consumers.  Industry representatives urged that any rules adopted by the Board should be clear to limit uncertainty and narrowly drawn to avoid unduly restricting credit.

In contrast, consumer advocates, state and local officials, and Members of Congress urged the Board to adopt regulations under HOEPA.  They acknowledged a proper place for guidance, but contended that recent problems indicate the need for requirements enforceable by borrowers through civil actions, which HOEPA enables and guidance does not.  They also expressed concern that less responsible, less closely supervised lenders are not subject to guidance and there is limited enforcement of existing laws for these entities.  Consumer advocates and others welcomed improved disclosures but insisted they would not prevent abusive lending.

<u>Legislative Action</u>

Congress has held a number of hearings in recent months on the mortgage market, particularly on problems in the subprime mortgage market.  The bill that has moved the furthest is H.R. 3915, the Mortgage Reform and Anti-Predatory Lending Act of 2007, which passed the House of Representatives on November 15. Introduced by Chairman Frank, Representative Miller, and Representative Watt, this comprehensive home loan reform bill would, among other things, establish a federal duty of care for mortgage originators, prohibit originators from steering consumers to more expensive loans by banning certain incentive compensation methods, including yield spread premiums, and require licensing and registration of mortgage originators, including mortgage brokers and bank loan officers. H.R. 3915 would also set minimum standards relating to borrowers' ability to repay for all mortgages and establish a requirement that refinancings provide a net tangible benefit to the consumer. The bill generally would provide for assignee liability against securitizers of loans that do not meet the minimum standards for ability to repay and net tangible benefit. Finally, for the highest-cost mortgage loans, H.R. 3915 would strengthen HOEPA's existing protections by expanding the restrictions that currently apply to such loans. The Senate has not yet considered this legislation, although Chairman Dodd has indicated his intent to introduce parallel legislation soon.

Other Outreach and Research Efforts

Board staff also solicited input from members of the Board's Consumer Advisory Council on issues presented by this proposal. During 2006 and 2007, for example, the Council on several occasions discussed abusive lending practices in the home mortgage market and various ways that the Board might address those practices. In addition, Board staff held meetings and conducted numerous conference calls with industry and consumer group representatives and representatives of other state and federal regulatory agencies in the process of developing this proposal.

**Discussion**

**A. <u>Scope of Mortgage Loans Covered by the Proposal</u>**

<u>Background</u>

Certain unfair, deceptive, or abusive practices may be prevalent in a limited segment of the market, such as the subprime mortgage market. Other such practices, however, may be prevalent in broader segments of the market, such as the entire mortgage market or all closed-end mortgages. Staff has sought to craft the scope of the proposed regulatory prohibitions on such practices to apply each new protection as broadly as needed to protect consumers from actual or potential injury from the practice in question, but not so broadly that the costs would clearly outweigh the benefits.

The June 14, 2007, HOEPA hearing notice solicited comment on the scope of any prohibitions on mortgage terms or practices, specifically whether such prohibitions should apply to all mortgage loans, or only to subprime mortgage loans. Some consumer and community groups favored applying some or all prohibitions to the entire mortgage market, while others stated that certain protections should apply to the entire market and other protections should apply only to subprime and nontraditional loans. Financial institutions and financial services groups generally believed that any new prohibitions should not be applied to the entire market. Most commenters suggested that, to the extent the Board targets subprime loans, it do so based on loan characteristics rather than borrower characteristics, such as credit scores.

Summary of Proposed Revisions

The proposal would apply some of the consumer protections to a subset of consumer mortgage loans, referred to as "higher-priced mortgage loans." The following protections would apply only to higher-priced mortgage loans:

- The prohibition on creditors' engaging in a pattern or practice of making higher-priced mortgage loans based on the collateral without regard to consumers' repayment ability;
- The prohibition on creditors' making an individual higher-priced mortgage loan without verifying by third-party documents the consumer income and assets the creditor relied upon to make the loan;
- The requirement to establish an escrow account for property taxes and homeowners' insurance for first-lien mortgage loans; and
- The prohibition on prepayment penalties except under certain conditions.

In addition, the proposal would prohibit structuring a loan as an open-end line of credit to evade the new protections for higher-priced mortgage loans.

The other consumer protections contained in the proposal, such as the restrictions on creditor payments to mortgage brokers, coercion of appraisers, and misleading advertisements, would apply to broader segments of the mortgage market.

"Higher-priced mortgage loans" would be defined as closed-end consumer credit transactions secured by the consumer's principal dwelling where the APR on the loan exceeds the yield on comparable Treasury securities by at least three percentage points for first-lien loans, or five percentage points for subordinate-lien loans. Higher-priced mortgage loans would include home purchase loans, refinancings of such loans, and home equity loans, but would not include mortgages on vacation properties, open-end home-equity plans, reverse mortgages, or construction-only loans. Loans to investors generally are not covered by TILA and HOEPA.

The proposal would set the APR triggers for higher-priced mortgage loans at levels designed to capture the subprime market, but generally exclude the prime market. There is, however, inherent uncertainty as to what levels would achieve these objectives because there is no single, uniform definition of the prime and subprime markets, and available data sets have inherent limitations. Based on available data, the proposed thresholds also would capture at least the higher-priced portion of the alt-A market. The proposal would request comment on whether different thresholds, such as four percentage points for first-lien loans, would better meet the objective of covering the subprime market and excluding the prime market and on ways to limit creditor circumvention of the APR thresholds.

## B. Prohibited Acts and Practices in Connection with Higher-Priced Mortgages

### 1. Ability to Repay

Background

Subprime loans generally are expected to default at higher rates than prime loans, but recent and significant increases in default rates among subprime loans suggest that originators of such loans may not have been taking adequate steps to ensure borrowers can repay them. When borrowers cannot afford to repay their loans, they suffer significant injury, such as loss of home equity or other assets, or foreclosure. Entire communities may experience a decline in homeowner equity if unaffordable loans are concentrated in specific neighborhoods, leading to a decline in property values.

Some borrowers may not understand that they are entering into unaffordable loans or may not be able to avoid entering into such loans. Borrowers may believe that the creditor's approval signifies that the creditor has verified the borrower's ability to repay the loan. Some loans may have affordable payments for an initial period, but the payments may increase to an unaffordable level after only a short period of time.

The June 14, 2007, HOEPA hearing notice solicited comment on alternative means of ensuring the borrowers' ability to repay. Some consumer and community groups who commented supported a requirement to underwrite ARMs using the fully-indexed, fully-amortizing rate. Other consumer and community groups recommended a requirement to underwrite to the maximum rate possible (taking into account interest rate increases), arguing that underwriting to the fully-indexed rate at the time of consummation would not assure that loans would be affordable over the full term of the loan. Financial institutions and financial services trade groups who commented agreed that underwriting a loan based on its fully-indexed interest rate and fully-amortizing payments is generally prudent, but most of these commenters opposed codifying such a standard in the regulation.

There does not appear to be any benefit to consumers from loans that are unaffordable at origination or immediately thereafter. However, consumers in certain circumstances may benefit from collateral-based loans or loans that offer low rates and payments that will increase after an initial period.

Summary of Proposed Revisions

TILA and Regulation Z currently prohibit creditors from engaging in a pattern or practice of extending HOEPA-covered loans to a consumer based on the consumer's collateral without regard to the consumer's repayment ability, including the consumer's current and reasonably expected income, current obligations, and employment. As noted above, HOEPA-covered loans are closed-end, non-purchase money mortgages secured by a consumer's principal dwelling (other than a reverse mortgage) where either: (a) the APR at consummation will exceed the yield on Treasury securities of comparable maturity by more than 8 percentage points for first-lien loans, or 10 percentage points for subordinate-lien loans; or (b) the total points and fees payable by the consumer at or before closing exceed the greater of 8 percent of the total loan amount, or $547 for 2007 (adjusted annually). HOEPA-covered loans are a very small portion of the subprime market.

The proposal would extend and apply to higher-priced mortgage loans the current prohibition against engaging in a pattern or practice of extending credit based on the collateral without regard to consumers' repayment ability for HOEPA-covered loans. There would be an exemption for bridge loans with a term no longer than twelve months. For higher-priced mortgage loans and HOEPA-covered loans, the proposal would establish rebuttable presumptions that a creditor has violated the rule when the creditor engages in a pattern or practice of failing to:

- Verify and document consumers' repayment ability;
- Consider consumers' ability to repay based on the interest rate as determined in the regulation for variable-rate loans by adding the margin and the index value as of consummation and for step-rate loans by calculating the highest interest rate possible within the first seven years of the loan's term;
- Consider consumers' ability to make loan payments based on a fully-amortizing payment that includes expected property taxes, homeowners' insurance, and certain other expenses;
- Consider the ratio of consumers' total debt obligations to income; or
- Consider consumers' residual income after paying obligations.

The proposed rule would also provide a safe harbor for creditors who have a reasonable basis to believe that consumers will be able to make loan payments for at least seven years after consummation of the transaction, considering the factors identified in the proposed rule and any other factors relevant to determining repayment ability.

For both higher-priced mortgage loans and HOEPA-covered loans, the proposal would:

- Clarify that a determination of whether a creditor has engaged in a prohibited pattern or practice is based on the totality of all facts and circumstances that existed as of consummation;
- Clarify that it may be appropriate or necessary in some circumstances to take into account expected changes in employment;
- Allow creditors to rely on assets other than collateral in determining repayment ability.

### 2. Verification of Income and Assets

Background

Over the past several years, an increasing number of home-secured loans have been underwritten without fully documenting or verifying the borrower's income and assets. Available data indicate that these stated income, low doc, or no documentation loans have become prevalent in the subprime market, as well as in the alt-A market.

The June 14, 2007, HOEPA hearing notice solicited comment on whether and to what extent stated income loans should be prohibited. Consumer and community groups who commented on this issue favored prohibiting stated income loans and requiring documentation of income or assets either for subprime loans or for all loans. Consumer representatives stated that creditors or brokers sometimes inflate consumers' incomes to ensure that credit will be granted and, as a result, many consumers obtain loans that they cannot afford. Most financial services firms and trade groups who commented on this issue generally opposed any prohibition on stated income loans. However, some financial institutions and industry trade groups supported imposing limited restrictions on stated income lending in the subprime market.

Stated income lending can harm consumers in several ways. First, borrowers who obtain stated income loans based on inflated income may be placed in unaffordable loans and experience difficulty making their payments, which can damage their credit histories and result in distressed home sales or foreclosure. Although some consumers may deliberately overstate their income, originators may inflate the income of consumers or mislead consumers into believing that income inflation is an acceptable practice. Second, consumers are typically charged a higher rate or fee for stated income loans and some borrowers who obtain stated income loans may not realize that they could have obtained less costly loans by documenting their income.

Stated income lending in the subprime market may benefit consumers who need a loan promptly or who cannot readily document their income. However, the potential benefits to consumers of stated income lending in the subprime market may be outweighed by the potential injury to consumers and competition.

Summary of Proposed Revisions

The proposal would prohibit creditors from relying on amounts of income, including expected income, or assets in extending credit for a higher-priced mortgage unless the creditor verifies such amounts. Verification may be based on the consumer's Internal Revenue Service Form W-2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income and assets, such as check-cashing receipts or a written statement from the consumer's employer. The proposal would not mandate underwriting standards for creditors, but would provide flexibility to allow creditors to adjust their standards for those consumers who traditionally may have had difficulty meeting full documentation underwriting requirements.

The proposal would also create a safe harbor for creditors who fail to verify income or assets before extending credit where verification of income or assets would not have altered the decision to extend credit or the terms of credit. Specifically, the safe harbor would apply if the amounts of income or assets that the creditor relied upon in extending credit are not materially greater than the amounts of the consumer's income and assets that the creditor could have verified when the loan was consummated. The proposal would solicit comment on whether subordinate-lien loans should be exempted from the verification requirement. Finally, the proposal would solicit suggestions for narrower alternatives that would impose fewer costs on creditors and consumers, while providing sufficient protection to consumers who may be injured by stated income lending.

### 3. Prepayment Penalties

Background

Prepayment penalty clauses are included in some mortgage contracts to offset the risk that the consumer may repay the mortgage before the end of the loan term. If a mortgage is prepaid by the consumer, the creditor must reinvest the funds at the current market rate. Prepayment may not allow the creditor to recoup certain fixed costs associated with making the loan. Prepayment penalties are commonly included in subprime mortgages, but generally are not included in prime mortgages.

The June 14, 2007, HOEPA hearing notice solicited comment on whether prepayment penalties should be restricted and whether enhanced disclosures about prepayment penalties would address concerns about abuses. Most consumer and community groups recommended that the Board ban prepayment penalties on subprime home loans or, at a minimum, require prepayment penalties for fixed rate loans to expire two years after loan origination and require prepayment penalties on subprime hybrid ARMs to terminate between sixty days and six months prior to the first rate adjustment on the loan. These groups stated that improved disclosures would not solve the problems associated with prepayment penalties in the subprime market. Most financial institutions and financial services trade groups recommended that the Board focus on improving disclosures and limit any substantive restrictions to a requirement that the penalty term on a subprime hybrid ARM end before the first rate adjustment. A majority of these commenters recommended that borrowers be allowed to refinance without penalty starting sixty days prior to the first reset.

Prepayment penalties may benefit borrowers who understand the trade-off between the interest rate and prepayment penalty, and voluntarily choose to accept a prepayment penalty in exchange for a lower interest rate. Prepayment penalties may make the secondary market more liquid, which may benefit borrowers by reducing interest rates and increasing credit availability.

Prepayment penalties, however, can impose substantial costs on borrowers and prevent some borrowers who cannot afford to pay the penalty from exiting unaffordable loans. For those borrowers who refinance and pay a prepayment penalty, the penalty can decrease the borrower's home equity and increase the borrower's loan balance if the penalty is financed into the new loan.

Concerns have been raised about the transparency of prepayment penalties and whether borrowers understand the risks that prepayment penalties pose to them. A recent FTC study suggests that, even with improved disclosure, it is questionable whether consumers can accurately factor a contingent, future cost, such as a prepayment penalty, into the price of a loan.[3] This transparency problem is compounded with respect to prepayment penalties because, unlike interest or points, the penalty is not included in the APR.

Summary of Proposed Revisions

TILA and Regulation Z currently restrict prepayment penalties for HOEPA-covered loans. As noted above, HOEPA-covered loans are a very small portion of the subprime market. For HOEPA-covered loans, prepayment penalties are prohibited unless: (a) the consumer's debt-to-income ratio at consummation does not exceed 50 percent of the consumer's verified monthly gross income;[4] (b) the source of the prepayment funds is not a refinancing by the creditor or its affiliate; (c) the penalty term does not exceed five years following consummation; and (d) the penalty is not otherwise prohibited by law.

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[3] James M. Lacko and Janis K. Pappalardo, Federal Trade Commission, Improving Consumer Mortgage Disclosures ES-9 (June 2007).

[4] The proposed rule, which would apply to all HOEPA-covered and higher-priced loans, would apply a stricter income verification standard for income that is not derived from employment than the existing statutory standard for HOEPA-covered loans. Currently, HOEPA requires the income and assets of the consumer to be verified by a financial statement signed by the consumer, by a credit report, and in the case of employment income, by payment records or by verification from the employer of the consumer. The proposed standard would require income verification by third-party documents for income that is not derived from employment.

The proposal would extend to higher-priced mortgage loans the prohibitions on prepayment penalties that currently apply only to HOEPA-covered loans. For higher-priced mortgage loans and HOEPA-covered loans, the proposal would also require that the period during which a permissible prepayment penalty may be imposed must expire at least sixty days prior to the first date, if any, on which the principal or interest payment may increase under the terms of the loan. This provision should allow the vast majority of subprime borrowers to refinance their mortgages without paying a prepayment penalty before the first payment increase takes effect. The proposal would solicit comment on the potential costs and benefits of the provisions regarding prepayment penalties.

### 4. Escrows

Background

Escrow accounts for property taxes and homeowners' insurance premiums are a common feature in the prime mortgage market. The benefits of escrows are that they reduce the likelihood that consumers will assume unaffordable mortgages, act as a kind of forced savings that relieves the consumer of the need to save separately to pay property taxes and homeowners' insurance premiums, and may reduce the risk of default. In the subprime mortgage market, however, it does not appear that most borrowers are offered the opportunity to escrow property taxes and homeowners' insurance premiums.

The June 14, 2007, HOEPA hearing notice solicited comment on whether escrows for property taxes and homeowners' insurance premiums should be required for subprime mortgage loans. Consumer and community groups urged the Board to require escrows on subprime mortgage loans. These groups argued that the lack of escrows in the subprime market enables originators to advertise and quote misleadingly low monthly payments and that subprime borrowers may not be aware of the need to save on their own for tax and insurance payments. Many creditors and financial services trade groups agreed that escrowing taxes and insurance is generally beneficial to subprime borrowers, lenders, servicers, and investors, although some of these commenters favored guidance, rather than a regulation, to address escrows. Testimony from the 2007 hearing also suggests that escrows may improve loan performance.

The lack of escrows in the subprime market appears to reflect a market failure. Originators that do not offer escrows to borrowers are able to quote monthly payments that do not include amounts for taxes and insurance. These originators appear to have a competitive advantage over originators that require or offer escrows. The result is a collective action problem where even though originators would benefit from escrows, individual originators do not offer escrows because doing so could put them at a competitive disadvantage.

This market failure can cause substantial injury to borrowers. A lack of escrows in the subprime market may make it more likely that borrowers obtain mortgages they cannot afford. Borrowers who cannot afford to save or have not been adequately informed of the need to save for taxes and insurance may not have the resources to pay tax and insurance bills when they come due. Failure to pay property taxes and homeowners' insurance premiums is generally an act of default which may subject the property to a public auction by the local government or an acquisition by a public agency. Borrowers faced with unpaid tax or insurance bills are particularly vulnerable to predatory lending practices. Borrowers cannot avoid this injury if they are not offered loans with escrow and do not understand the risks and responsibilities associated with a non-escrowed loan. Although the practice of not escrowing potentially can benefit borrowers who can separately meet their property tax and homeowners' insurance obligations, these benefits may be outweighed by the injury to borrowers from not having an opportunity to escrow on higher-priced mortgages.

Summary of Proposed Revisions

The proposed amendments would prohibit a creditor from making higher-priced loans secured by a first-lien on the consumer's principal dwelling without establishing an escrow account for property taxes and homeowners' insurance premiums. A creditor would be permitted, but not required, to offer the borrower the opportunity to "opt out" of, or cancel, the escrow twelve months after consummation. This twelve month time period is designed to prevent circumvention of the rule by creditors and to educate borrowers about the benefits of escrowing. An "opt out" available before, at, or immediately after consummation would be subject to manipulation and could allow circumvention. The proposal seeks comment on whether a different period of time would be appropriate. Some state laws limit creditors' ability to require escrows or provide consumers a right to cancel an escrow less than twelve months after closing. The proposal would solicit comment on whether it is appropriate to preempt those laws.

## C. Prohibited Acts and Practices in Connection with Closed-End Credit Secured by a Consumer's Principal Dwelling

The proposals that address creditor payments of yield spread premiums to mortgage brokers, coercion of appraisers, and loan servicing would apply to closed-end consumer credit transactions secured by a consumer's principal dwelling. The proposed prohibitions would not apply to open-end home-equity plans. The acts and practices addressed in this section do not appear to be limited to the subprime market. Thus, the proposed prohibitions are not limited to higher-priced mortgage loans.

### 1. Yield Spread Premiums (Mortgage Broker Compensation)

Background

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

The creditor's payment of a yield spread premium to the broker is an alternative to the consumer's paying the broker directly from the consumer's preexisting resources or loan proceeds. A consumer may choose not to pay the broker directly if the consumer lacks the resources or the equity to pay all closing costs in cash or out of loan proceeds, or prefers to shift some or all closing costs, including broker compensation, into a higher rate.

Although the Board did not solicit comment on mortgage broker compensation in connection with the 2006 and 2007 HOEPA hearings, a number of commenters and some panelists raised concerns about creditor payments of yield spread premiums to mortgage brokers. Consumer group and creditor representatives alike questioned the fairness and transparency of creditor payments to brokers. They stated that consumers generally are not aware of the incentive these payments give brokers to increase consumers' interest rates, and that consumers may mistakenly believe that a broker's only objective is to obtain the best interest rate available. Consumer groups suggested prohibiting creditors from paying brokers yield spread premiums, imposing on brokers who accept yield spread premiums a fiduciary duty to consumers, imposing on creditors that pay yield spread premiums liability for broker misconduct, or including yield spread premiums in the points and fees test for HOEPA coverage. Several creditors and creditor trade associations suggested requiring brokers to disclose to the consumer whether the broker represents the consumer's interests, how and by whom the broker is to be compensated, and the amount of their total compensation. Some of these entities recommended prohibiting creditors from paying brokers more than the disclosed amount.

Significant concerns have been raised about the fairness and transparency of creditor payments to mortgage brokers. It is likely that many consumers do not know that creditors pay brokers based on the interest rate and mistakenly believe that the broker will obtain the best interest rate available for the consumer. Some consumers may not even know that creditors pay brokers because it is a common practice for brokers to charge a small part of their compensation directly to the consumer. Consumers who do not understand how creditors compensate brokers may not realize that brokers have an incentive to increase the rate in the consumer's loan transaction in order to maximize the broker's compensation. Finally, consumers who do not understand the broker's incentives may be less likely to shop for rates from various sources or shop and negotiate for brokers' services.

Summary of Proposed Revisions

The proposal generally would prohibit creditors from making any payment, directly or indirectly, to a mortgage broker in connection with a closed-end consumer credit transaction secured by a consumer's principal dwelling, unless the mortgage broker first enters into a written agreement with the consumer that meets certain specified conditions. The mortgage broker and consumer must enter into this written agreement before the consumer pays a fee to any person in connection with the transaction or submits a written application to the broker for the transaction, whichever is earlier. The written agreement must clearly and conspicuously state: (1) the total dollar amount of compensation the broker will receive and retain from all sources; (2) that the consumer will pay the entire amount of compensation that the broker will receive, even if all or part of that compensation is paid directly by the creditor; and (3) that creditor payments to a mortgage broker can influence the broker to offer certain loan products or terms to the consumer that are not in the consumer's interest or are not the most favorable the consumer otherwise could obtain. Under the proposal, creditor payments to a mortgage broker could not exceed the total compensation amount stated in the written agreement, reduced by any amounts paid directly by the consumer or from any other source.

The proposal would preserve a consumer's option to pay a broker indirectly by accepting a higher interest rate when a written agreement between the consumer and the mortgage broker provides the information described above. The proposal should improve the transparency of broker compensation, as well as the role of brokers, and make it more likely that consumers will shop for and negotiate among brokers based on broker fees and services.

The proposal would not prohibit a creditor payment to a mortgage broker in a transaction subject to a state statute or regulation that: (a) expressly prohibits the broker from being compensated in a manner that would influence a broker to offer loan products or terms not in the consumer's interest or not the most favorable the consumer could obtain; and (b) requires that a mortgage broker provide consumers with a written agreement that includes a description of the mortgage broker's role in the transaction and the broker's relationship to the consumer. For example, the proposed prohibition would not apply if a state statute or regulation imposes a fiduciary obligation on a mortgage broker not to put its own interests ahead of the consumer's interests and requires the broker to disclose this obligation in the agreement with the consumer.

The proposal also would not prohibit a creditor payment to a mortgage broker if the creditor can demonstrate that the compensation it pays to a mortgage broker in connection with a transaction is not determined, in whole or in part, by reference to the interest rate for the transaction. For example, the prohibition on creditor payments to brokers would not apply if a creditor can show that it pays brokers the same flat fee for all transactions, regardless of the interest rate. The prohibition also would not apply if a creditor can show that its payments to brokers varies based solely on factors other than the interest rate, such as loan principal amount.

Although the proposed rule would impose costs on creditors and brokers, the benefits provided by greater transparency regarding creditor payments to brokers may outweigh those costs. The proposal would solicit comment on the costs and benefits of the proposed restrictions on creditor payments to brokers.

The proposal is intended to be consistent with the treatment of broker compensation under section 8 of the Real Estate Settlement Procedures Act (RESPA) and guidance that has been issued by the Department of Housing and Urban Development (HUD) regarding creditor compensation of brokers.

**2. Coercion of Appraisers**

Background

Although the Board did not solicit comment on the coercion of appraisers in connection with the 2006 and 2007 HOEPA hearings, a number of panelists at the hearing and commenters raised concerns about inflated appraisals in the home mortgage market and the coercion of appraisers to issue inflated appraisals. A number of trade associations representing appraisers urged the Board to declare the coercion of appraisers to be an unfair or deceptive act or practice.

Pressuring an appraiser to understate or overstate the value of a consumer's dwelling can distort the lending process and harm consumers. An inflated appraisal can lead a consumer to think he or she has more home equity than he or she in fact has and to borrow or make other financial decisions based on this incorrect information. For example, a consumer who purchases a home based on an inflated appraisal may overestimate his or her ability to refinance, and may enter into a riskier loan than he or she otherwise would have. Inflated appraisals of homes concentrated in a neighborhood may affect other appraisals, since appraisers factor the value of comparable properties into their property valuations.

Summary of Proposed Revisions

The proposal would prohibit a creditor or mortgage broker from coercing, influencing, or encouraging an appraiser to misrepresent the value of a consumer's principal dwelling. The term "appraiser" means a person who engages in the business of providing assessments of the value of dwellings. An "appraiser" includes persons that employ, refer, or manage appraisers, and affiliates of such persons. Examples of acts that would violate the prohibition include implying to an appraiser that retention of the appraiser depends on the amount at which the appraiser values a consumer's principal dwelling, or failing to compensate an appraiser or to retain the appraiser in the future because the appraiser does not value a consumer's principal dwelling at or above a certain amount.

The proposal also would prohibit creditors from extending credit when a creditor knows or has reason to know, at or before loan consummation, that a person has coerced, influenced, or encouraged an appraiser to misstate the value of a consumer's principal dwelling, unless the creditor acts with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of such dwelling.

### 3. Loan Servicing

Background

The growth of securitization in the mortgage market has made mortgage loan servicers an important player in the mortgage process. Indeed, the servicer is often the only entity with which the borrower will have contact in the normal course of repayment and in the event the borrower defaults. Concerns have been raised about abusive practices by servicers, including practices that may allow servicers to obtain unwarranted fees from borrowers.

Although the Board did not solicit comment on mortgage loan servicers in connection with the 2006 and 2007 HOEPA hearings, some commenters, particularly consumer advocates, raised concerns about servicers. They noted that servicers have an incentive to charge late fees and other "service" fees in the normal course of mortgage servicing, as well as in foreclosure. Consumer advocates have also raised concerns about the transparency of fees.

Servicers generate revenue through a combination of a fixed per-loan or monthly fee, float income, and ancillary fees—including default charges—that the consumer must pay. Borrowers generally do not choose, and cannot change, their servicer (without refinancing). Furthermore, so long as investor returns are maximized, investors may be indifferent to the fees the servicer charges the borrower. As a result, servicers do not compete in any direct sense for consumers. Thus, there may not be sufficient market pressure on servicers to ensure competitive practices.

Substantial anecdotal evidence raises concerns about abusive servicing practices. Some servicers may not timely credit, or may misapply, payments, which can result in the imposition of improper late fees. Some servicers may also apply future principal and interest payments to a late fee first, making it appear that subsequent payments are delinquent, even if they are paid in full and on time. This practice is sometimes referred to as "pyramiding" of late fees. In addition, it is not clear that servicer fees are transparent to the consumer. Finally, some servicers may fail to provide a payoff statement to consumers in a timely manner, thus impairing the ability of consumers to refinance or otherwise pay off existing loans. Market forces may not be adequate to restrain abusive servicing practices.

Summary of Proposed Revisions

The proposal would prohibit four practices by servicers in connection with consumer credit transactions secured by a consumer's principal dwelling. First, the proposal would prohibit a servicer from failing to credit a payment to the consumer's account as of the date of receipt, except when a delay does not result in any charge to the consumer or a report of negative information to a consumer reporting agency. A servicer that accepts non-conforming payments must credit the payment within five days of receipt. This provision would be substantially similar to the existing provision in Regulation Z requiring the prompt crediting of payments received on open-end plans.

Second, the proposal would prohibit a servicer from imposing a late fee or delinquency charge on the consumer in connection with a payment when: (1) the only delinquency is attributable to late fees or delinquency charges assessed on an earlier payment; and (2) the payment is otherwise a full and timely payment for the applicable period. This provision would be substantially similar to the current prohibition on the "pyramiding" of late fees found in the Board's Regulation AA at 12 C.F.R. 227.15.

Third, the proposal would prohibit a servicer from failing to provide the consumer with a schedule of all specific fees and charges that the servicer may impose on the consumer within a reasonable time after the consumer's request for such a schedule. The schedule must include a dollar amount and an explanation of each such fee and the circumstances under which it will be imposed. This provision is designed to provide greater transparency with regard to servicer fees.

Fourth, the proposal would prohibit a servicer from failing to provide an accurate payoff statement—a statement of the total outstanding balance of the consumer's obligation that would be required to satisfy the obligation in full—within a reasonable time after receiving a request from the consumer for such a statement. Generally, the proposal would provide that three business days is a reasonable time for providing payoff statements, although the time may be longer when servicers experience an unusually high volume of requests. This provision is designed to limit delays by servicers that may impair the ability of consumers to refinance or otherwise pay off loans.

**D. Advertising**

Background

Regulation Z currently contains rules that apply to advertisements of open-end home-equity plans and closed-end mortgage credit. The advertisement of rates is addressed in these rules. In addition, if an advertisement contains certain specified credit terms, including the payment terms, this triggers a requirement to provide additional advertising disclosures, such as the APR.

A review of recent advertisements for mortgage loans shows that some advertisements emphasize low introductory or "teaser" rates or payments that will only be in effect for a limited period of time. These advertisements generally disclose the rates or payments that will apply after the low introductory rates or payments expire in a much less conspicuous manner, such as in much smaller type or in a footnote. Some advertisements also promote a rate, such as an "effective" rate or "payment" rate, that is lower than the rate at which interest is accruing. Advertisements such as these do not provide consumers with accurate or balanced information about the cost of credit over the term of the loan and the obligations that consumers would assume under the mortgage.

In addition, certain practices connected with closed-end mortgage advertisements appear to be misleading for consumers. For example, certain closed-end mortgage advertisements for adjustable-rate mortgages use the term "fixed" in a way that could mislead the consumer into believing that the product is a fixed-rate mortgage. Other such advertisements suggest that the federal government sponsors or endorses the loan product being advertised.

The issues identified above appear to exist in advertisements for all mortgage loans, not just advertisements for higher-priced loans.

Summary of Proposed Revisions

Advertising rates or payments. The proposed amendments would require that whenever a rate or payment is included in an advertisement for closed-end or open-end credit secured by a dwelling, all rates or payments that will apply over the term of the loan (and the time periods for which those rates or payments apply) must be disclosed with equal prominence and in close proximity to the advertised rate or payment. For example, if the advertised monthly payment is $1,000, but increases to $2,000 after six months, the payment increase and the limited duration of the initial monthly payment could not be disclosed in smaller type or in a footnote, but would have to be disclosed close to and as prominently as the $1,000 initial monthly payment. The proposed amendments would also strengthen the clear and conspicuous standard, as it applies to advertisements. These revisions would apply to both closed-end and open-end mortgage advertisements. For closed-end mortgage advertisements, the proposed amendments would no longer allow the advertisement of any interest rate lower than the rate at which interest is accruing on an annual basis.

Prohibited practices in closed-end mortgage advertisements. The proposed amendments would prohibit the following practices in advertisements for closed-end mortgage loans:

- Advertising "fixed" rates or payments without adequately disclosing that the interest rate or payment amounts are "fixed" only for a limited period of time, rather than for the full term of the loan;

- Comparing an actual or hypothetical consumer's current rate or payment obligations and the rates or payments that would apply if the consumer obtains the advertised product, unless the advertisement states the rates or payments that will apply over the full term of the loan;

- Advertisements that characterize the products offered as "government loan programs," "government-supported loans," or otherwise endorsed or sponsored by a federal or state government entity, unless the loans are government-supported or sponsored loans, such as FHA or VA loans;

- Advertisements that prominently display the name of the consumer's current mortgage lender, unless the advertisement also discloses the fact that the advertisement is from a mortgage lender that is not affiliated with the consumer's current lender;

- Advertising claims of debt elimination if the product advertised would merely replace one debt obligation with another;

- Advertisements that falsely create the impression that the mortgage broker or lender has a fiduciary relationship with the consumer; and

- Foreign-language advertisements in which certain information, such as a low introductory "teaser" rate, is provided in a foreign language, while required disclosures are provided only in English.

These prohibitions would apply to advertisements for all closed-end mortgage loans, but would not apply to advertisements for open-end home-equity plans. Staff did not observe the practices described above in advertisements for home-equity plans. The proposal would solicit comment, however, on whether these or other practices should be prohibited in advertisements for home-equity plans.

**E. <u>Timing of Disclosures</u>**

<u>Background</u>

Regulation Z currently provides that a creditor must make certain early disclosures to consumers in connection with a purchase money mortgage transaction (also known as a "residential mortgage transaction") subject to the Real Estate Settlement Procedures Act. For these transactions, the creditor must make a good faith estimate of the disclosures before loan consummation, or deliver or place them in the mail not later than three business days after the creditor receives the consumer's written application, whichever is earlier. The required disclosures include the payment schedule, total of payments, finance charge, amount financed, and annual percentage rate.

The current rule does not require "early" disclosures for non-purchase money mortgage transactions, such as mortgage refinancings, closed-end home equity loans, and reverse mortgages. Currently under Regulation Z, creditors need not provide mortgage loan disclosures to consumers in non-purchase money mortgage transactions until consummation. By the time of consummation, consumers may not be in a position to use the disclosures to shop for a mortgage or to inform themselves adequately of the terms of the loan.

The current rule also does not restrict the imposition of fees, such as non-refundable application fees, before good faith estimate disclosures have been provided to the consumer. Imposing such fees before transaction-specific disclosures have been provided may have the effect of limiting shopping by consumers.

Summary of Proposed Revisions

The proposal would revise the current rule to require creditors to provide early good faith estimate disclosures to consumers in both purchase money and non-purchase money closed-end mortgage transactions. In addition, the proposal would prohibit a creditor or any other person from imposing a fee on the consumer in connection with the consumer's application for a closed-end mortgage transaction until after the consumer has received the disclosures. For purposes of determining when a fee may be imposed, the consumer would be deemed to have received the disclosures three business days after they are mailed. This fee restriction would not apply to a reasonable and bona fide fee for obtaining the consumer's credit history, such as a credit report fee. Providing transaction-specific information within three days of application and before the consumer has paid a fee would help to ensure that consumers have a meaningful opportunity to review the credit terms being offered, assess whether the terms meet their needs and are affordable, and decide whether to proceed with the transaction or continue to shop among alternatives.

**Conclusion**

Staff recommends that the Board publish for public comment the draft proposed amendments to Regulation Z to: (1) prohibit certain acts or practices for higher-priced mortgage loans and prohibit other acts or practices for closed-end credit transactions secured by a consumer's principal dwelling; (2) revise the disclosures required in advertisements for credit secured by a consumer's dwelling and prohibit certain practices in connection with closed-end mortgage advertising; and (3) require disclosures for closed-end mortgages to be provided earlier in the transaction.