Comments of the

Consumer Federation of America

Regarding

Advance Notice of Proposed Rulemaking
Implementation of the Bankruptcy Act Amendments
To Truth in Lending

Federal Reserve System
12 CFR Part 226

Docket No. R-1217

The Consumer Federation of America makes the following recommendations regarding steps the Federal Reserve Board should take to implement Title 13 of S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23. We focus our comments on Section 1301, which amends the Truth in Lending Act (TILA) to require disclosures regarding minimum payments on open-end accounts, and Section 1302, which requires additional disclosures under TILA for home secured loans that may exceed the fair-market value of the dwelling.

I. MINIMUM PAYMENT DISCLOSURES

A. All cardholders should receive mandated disclosures.

Question 60 of the Board's Advance Notice of Proposed Rulemaking asks whether the Board should permit creditors to omit minimum payment disclosures from periodic statements for cardholders who do not revolve balances or who make monthly payments that regularly exceed the minimum. We emphatically recommend that no such exceptions be made because such exceptions would undermine the intent of these disclosures. The purpose of this requirement is to provide useful information to cardholders about the consequences of paying at or near the minimum rate. Whether someone is paying the minimum 2 percent balance or making a payment just above that level of 5 percent of the balance, he or she could benefit from information about the length of time it would take to pay off balances in extremely small increments.

At any one time, a significant number of Americans are paying at or near the minimum rate. In a survey conducted for the Consumer Federation of America by Opinion Research Corporation in early November of this year, 34 percent of those questioned said that they usually pay the minimum rate or somewhat more. More than 40 percent of respondents earning less than $50,000 a year said they paid the minimum rate or somewhat more, while 45 percent of African Americans and 51 percent of Hispanics did so.[1] An examination by the Credit Research Center of 310,000

[1] Opinion Research Corporation, "Consumer Financial Services Survey," November 3-7, 2005.

active credit card accounts over 12 consecutive months in 2000 and 2001 found similar results. Just under one-third of the accounts paid 5 percent or less per month of the total amount due.[2]

Moreover, payment habits for many cardholders are not static over time. Depending on the economic circumstances of the cardholder involved, he or she could shift from fully paying outstanding balances every month to paying at or near the minimum rate. Because of the large number of cardholders who make payments at or near the minimum rate and this potential for flux, it is essential that the information required in this law be made available to all cardholders.

Relative to questions 59 and 63, CFA also recommends that the disclosure requirements apply to all open end accounts, including home-equity lines of credit and general-purpose credit lines with fixed repayment schedules. Borrowers of these types of open end loans could realize significant financial benefits if they paid more than the minimum that is required. Of course, the Board will have to direct lenders to alter the required disclosures to reflect the unique features of these products. CFA endorses the specific recommendations made by the National Consumer Law Center in its comments regarding how the Board should require lenders of these products to modify mandated disclosures.

B. <u>All</u> disclosures required or allowed under the statute must be located in a highly visible location on the front of the billing statement.

Questions 83 and 84 ask about how the Board should implement statutory requirements regarding the format and conspicuousness of mandated disclosures. No single question regarding the implementation of these disclosures is more important than assuring that consumers actually see them. The intent of Congress would be undermined if creditors were permitted to place any disclosure that is required or allowed under the Act in a location that is not highly visible to the consumer, such as on any page of the billing statement other than the front.

The Act requires that minimum payment "hypothetical" disclosures must be "in a prominent location on the front of the billing statement, disclosed clearly and conspicuously." To meet this requirement, CFA recommends that the Board require creditors to segregate the disclosure in an area of the billing statement that is as close as possible to the two items on the statement to which consumers pay the most attention: the date that payment is due and the minimum payment that is required. The goal of segregating the disclosure would be to make it visibly stand apart from the rest of the statement, through the use of a shaded area, a border, different colored ink, etc. The typeface should be no smaller than the largest type on the rest of the statement, but in no event should it be smaller than 10 points in size.

The Board should also require creditors to meet these formatting requirements -- especially the requirement that the disclosure be on the front of the billing statement -- for additional disclosures allowed under the Act. Section 1637(b)(11)(k) of the Truth in Lending Act, for example, now allows creditors to provide an alternative disclosure on the billing statement if the creditor notifies consumers of a toll-free phone number that allows consumers to obtain the "actual" number of months that it will take to repay an outstanding balance. The Act does not explicitly require that

[2] Credit Research Center, McDonough School of Business, Georgetown University.

this optional disclosure be on the front of the billing statement. However, unless the Board does so, very few consumers will see this disclosure, which is clearly not what Congress intended. Moreover, if the Board does not require that the optional disclosure meet the same standards for conspicuousness as must be met for "hypothetical" disclosures, the Board would be providing a unwarranted incentive for creditors to chose a disclosure option that is less specific, less compelling and – most importantly – less visible to consumers.

Correspondingly, if the Board allows creditors to provide consumers with information on the billing statements as to how many months it will take to pay off the actual balance – as CFA hopes the Board will do – it should also require that this disclosure meet the same standards for conspicuousness as are required in the Act and detailed above.

C. The Board should allow and encourage creditors to disclose the time it would take consumers to pay off actual balances on the front of the periodic statement.

Question 82 asks whether the Board should encourage creditors to disclose to consumers on the billing statement how long it would take to pay off their actual balances. This is by far the most helpful disclosure option for consumers that is allowed or required under the Act. As stated above, we urge the Board to require that if such disclosure is provided, it be on the front of the billing statement in order to ensure that it is highly visible.

Such disclosures would also decrease the regulatory burden on creditors. By informing consumers how long it would take to pay off their balances on the billing statement, creditors would not have to shoulder the costs of maintaining the toll-free number to provide this information over the phone. Moreover, the amount of text required to provide this disclosure would be less than that mandated for the "hypothetical" disclosure on the front of the billing statement, a fact that creditors might also find appealing.

We encourage the Board not only to allow this option, but to do everything in its power to encourage creditors to use it.

D. Payoff time "estimates" provided to consumers through toll-free numbers must be reasonably accurate.

Questions 65 through 75 ask about what methodologies the Board should use or require creditors to use in providing an "estimate" to consumers (through an automated toll-free number) about how much time it would take to repay their balances in full. We suggest that before the Board immerses itself in the details of how it will develop the estimate that it first determine what will be the standard of accuracy for the estimate. The Webster's II Dictionary defines "estimate" to mean "to calculate approximately the extent of." Clearly, then, such a requirement does not require total precision in estimating how long it will take consumers to pay off their balances. On the other hand, if the estimate is not reasonably accurate, it could mislead consumers and cause them to make unwise financial decisions. It would be especially important, for example, that payoff estimates be more precise for smaller balances with shorter payoff periods than for loans that would take longer to pay off.

CFA therefore recommends that the Board require that these estimates meet a standard of 90 percent accuracy for each loan that would be paid back in fewer than ten years and 80 percent accuracy for each loan that would be paid back in more than ten years. It will be important for the Board to develop a methodology to ensure that this standard is met for all borrowers, regardless of whether the terms of the loan are "typical" or not. In order to assure that such a standard is maintained (by either the Board, the FTC or creditors), it will be necessary for the Board to set up procedures to audit the accuracy of the estimates that are provided on a regular basis.

In response to Question 76, consumers should be informed at the point in time that they receive the estimate (either when they call the toll free number or on their statement, if the estimate is on the statement) that the information they receive is only an estimate that meets a standard of accuracy of 90 percent (or 80 percent) and that, by law, the estimate was made based on the assumption that the consumer does not use additional credit and makes only the minimum payments.

Once the Board has determined what the standard of accuracy will be, it can then chose between the various options it is considering, to calculate this estimate to the mandated standard. As long as the standard is met, this methodology could include the use of assumptions by the Board or require that creditors input information from their own systems. However, in response to question 69, if the Board uses assumptions to calculate the estimate, it should never use an assumption that corrects a detrimental practice being used by a creditor, such as negative amortization. In cases involving negative amortization, consumers should be informed immediately of that fact.

E. Disclosure of "actual" times to pay off loans should be extremely accurate.

As stated above, the Act as amended now allows creditors to provide an alternative disclosure on the billing statement if the creditor notifies consumers of a toll-free phone number that allows consumers to obtain the "actual" number of months that it will take to repay an outstanding balance. Questions 77, 78 and 79 inquire about how the Board should implement this provision.

We suggest a similar approach to that proposed above for the disclosure of "estimated" payoff times with a higher standard of accuracy. As the law requires that the "actual" time to pay off must be disclosed, the standard of accuracy must be as high as possible. We suggest that creditors meet a standard of 99 percent accuracy for loans that will be paid off within ten years and 98 percent accuracy for payoff times of more than ten years. Once again, the Board's focus should be on determining whether creditors are meeting the standard for all cardholders, not on how the payoff time is determined. It does seem highly unlikely, however, that creditors would be able to provide the actual payoff time accurately by using assumptions developed by the Board.

F. Interest rates for hypothetical examples should be regularly recalculated, but only if proper methodology is used.

Regarding the calculation of interest rates used in the hypothetical examples required by the Act (Question 62), it makes perfect sense for the Board to recalculate this interest rate on occasion to reflect market realities, whether average interest rates goes up or down. However, recalculation should only be done if the Board calculations are based on assumptions that are fair and accurate for most cardholders. For example, it would be not be accurate for most cardholders if the Board recalculated the 17 percent APR currently used in the hypothetical example by averaging the APRs from all commercial banks that the Board collects and releases annually. That is because the average APR that is calculated using this methodology gives equal weight to interest rates being charged by small commercial banks with few cardholders, as to interest rates charged by large banks that control a significant share of the credit card market. Any recalculation of the hypothetical interest rate should accurately reflect the rates that most cardholders pay. That means that such a calculation should give greater weight to the actual interest rates (including penalty rates) charged by the issuers with greater market share.

II. INTRODUCTORY RATE DISCLOSURES
III. CREDITING OF PAYMENTS
IV. INTERNET DISCLOSURES

CFA endorses the recommendations offered by the National Consumer Law Center in its comments on these sections.

V. DISCLOSURES FOR HOME-SECURED LOANS THAT MAY EXCEED THE DWELLING'S FAIR-MARKET VALUE

The Bankruptcy Act requires mortgage lenders to offer additional disclosures to borrowers whose loans exceed or may exceed the fair-market value of the dwelling that secures the loan. Loans that exceed the value of the underlying asset are extremely risky for consumers, who could face the possibility of foreclosure, damage their credit, or forestall home resale or bankruptcy. Too many consumers believe that real estate will automatically increase in value, and thus are willing to take on risky loans secure in the faith that market appreciation is a sufficient hedge against the risk of the terms of the loan or loans.

Increasingly, the home mortgage market is offering products to borrowers that could leave consumers owing more debt than their homes are worth. Additionally, some consumers could take on more debt through a series of mortgages and lines of credit than the underlying asset may be worth. In some cases, the cap on adjustable rate mortgage recalibrations could limit the payment increases for the borrower but not the accumulation of debt, leaving the borrower with an increasing debt load. Regardless of the mechanism by which this negative amortization occurs, consumers should receive two types of disclosures: first, before they sign the note, they must be informed that there is a potential for the loan to negatively amortize and what the implications of negative amortization are for the borrower, and, second, they should be informed after the first payment that allows the loan to negatively amortize and for every monthly mortgage statement when their debt is greater than the size of the loan at origination.

CFA believes that many consumers are not fully aware of the financial implications of many non-traditional mortgage products over the long term. Consumers need to understand how these mortgage products work and how the terms of these mortgages will impact their families' finances over the lifetime of the mortgage. The proliferation of new mortgage products may not be appropriate for all borrowers who receive them, and over the long term these mortgages could threaten the homeownership sustainability.

Many new borrowers appear to be choosing loan products based on the initial payment structure with little appreciation of the long-term costs of the mortgage. A recent Mortgage Bankers Association research brief noted that "There is an overriding belief that borrowers are overly focused on finding the mortgage that has an initial payment that will get them into a property, while ignoring potential payment shocks down the road."[3] Sophisticated borrowers with strong financial positions may benefit from non-traditional mortgages, but borrowers who are choosing these mortgage products to maximize affordability could unwittingly end up losing their homes because of negative amortization, payment shocks and erosion in their home's equity.[4]

The marketplace appears to be downplaying the risk of loans which could exceed the value of the property which secures them. One California mortgage broker described many prospective borrowers' attitudes as "Why knock ourselves out trying to build up equity through the mortgage payments when the market will take care of it for you?"[5] Comptroller of the Currency, John Dugan, indicated concerns about whether borrowers really understand the potential consequences of negative amortization mortgages in a speech before the Consumer Federation of America.[6]

Negative amortization lending is increasing at the same time that the real estate market seems to be cooling. Many lenders are offering Option Only mortgages, which allow borrowers to make amortizing payments, make interest only payments, or make minimum payments which do not even cover the interest costs of the loan. The lowest payments actually increase the size of the borrower's mortgage obligation, as the deficit between what the borrower pays and owes is added to mortgage debt. A 2005 *Wall Street Journal*/Harris Interactive poll found that overall 4 percent of households had a payment option mortgage.[7] However, option ARMs have been an increasing component of mortgage originations. In the first five months of 2004, less than one in twenty mortgages were option ARMs, but in the first five months of 2005, option ARMs made up 25 percent of prime and Alt-A mortgages.[8]

This can be disastrous for less sophisticated consumers who could enter these mortgages unwittingly. Borrowers can be lured into these mortgages with initial teaser interest rates that can be as low as one percent but last only a few months.[9] One lender that specializes in option ARMs, Golden West Financial's Herb Sandler, noted recently that some lenders are not fully explaining or disclosing the risks of option ARMs and "are clearly faking their borrowers out."[10]

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[3] Fratantoni, Michael, Mortgage Bankers Association, "Housing and Mortgage Markets: An Analysis," MBA Research Monograph Series No. 1, September 6, 2005 at 42.
[4] Fitch Ratings, "U.S. Mortgage Products: Only Time Will Tell," September 22, 2005 at 3.
[5] Pender, Kathleen, "High Interest in Interest-Only Home Loans," *San Francisco Chronicle*, May 20, 2005.
[6] Dugan, John C., Comptroller of the Currency, Remarks before the Consumer Federation of America, December 1, 2005 at 10.
[7] Bright, Becky, "A Third of U.S. Homebuyers Use Creative Mortgages Poll Finds," September 9, 2005.
[8] Office of Thrift Supervision, "Option ARMS: Part One," *The Quarterly Review of Interest Rate Risk*, Vol. 10, Iss. 2, Second Quarter, 2005 at 3.
[9] Simon, Ruth, "A Trendy Mortgage Falls from Favor," November 29, 2005.
[10] Eisinger, Jesse, "Investors Fret Mortgage Balloons Will Burst," *Wall Street Journal*, July 27, 2005.

Indeed, many borrowers are entering into loans which immediately negatively amortize without any disclosure from the lenders. Although borrowers can choose to repay their loan under a number of options, the majority of borrowers are only making the smallest possible payments. Some industry analysts estimate that 70 percent of option ARM borrowers are currently making only the minimum payments.[11] Fitch Ratings reports that a significant number of new option ARMs immediately begin to negatively amortize upon origination.[12]

Consumers are easily confused by the newfound variety of mortgage products, and lenders are doing an inadequate job explaining the differences between products, the implications for borrowers over the life of the mortgage and fully disclosing the risks of different products. In 2004, the Federal Trade Commission filed an injunction against a mortgage broker and lender in Nevada for advertising negatively amortizing option ARM payments as "low fixed payments" without clearly stating that the interest rates were not fixed and that the lowest payments were not "savings" to the borrower since they increased the borrower's debt.[13] In 2005, a borrower filed suit against Chevy Chase Bank after the initial teaser rate elapsed and the interest rate more than doubled from 1.95 percent to 4.375 percent two months after the loan was closed because the family believed the teaser rate was for the entirety of the period before the loan adjusted its interest rate.[14]

In light of these changes in the marketplace and the risks that borrowers face, CFA recommends that borrowers receive clear notification that loans have the potential to negatively amortize and are informed at the moment their payment level is accruing additional debt.

Q102: What guidance should the Board provide in interpreting "when an extension of credit may exceed the fair-market value of the dwelling?"

The Federal Reserve should ensure that all consumers are fully informed, clearly, conspicuously and often, whenever they enter into a mortgage which <u>potentially</u> could exceed the fair-market value of the property. During the application for a loan, potential borrowers should be informed that the loan or line of credit has the potential to make them liable for more debt obligation than the property is worth. Under those circumstances, borrowers should be advised that in order to satisfy the terms of the loan, they would have to pay more than they could recoup from the sale of the property.

CFA also recommends that lenders be required to inform borrowers at the point when they begin to negatively amortize their loan. Lenders should be required to include in their loan billing documentation a disclaimer to all borrowers who are negatively amortizing that their payments are insufficient to remain current on their loan and that the failure to pay at least the interest portion of their loan will result in the size of the principal debt increasing.

Q103: Should the potential for future indebtedness through negative amortization be considered when determining whether debt may exceed the value of the dwelling?

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[11] Simon, Ruth, "A Trendy Mortgage Falls from Favor," November 29, 2005.
[12] Fitch Ratings, "U.S. Residential Mortgage Products: Only Time Will Tell, September 22, 2005 at 4.
[13] *See* Federal Trade Commission v. Chase Financial Funding et al, Case No. SACV04-549 GLT, U.S. District Court, Central District of California, May 11, 2004.
[14] Simon, Ruth, "A Trendy Mortgage Falls from Favor," November 29, 2005.

The Federal Reserve should require the disclosure of the potential for negative amortization to arise from any mortgage or the assumption of multiple mortgages or credit lines if they could result in the borrower owing more than the dwelling is worth. This is an increasingly common situation as more borrowers take out option ARM loans that are designed to allow borrowers to negatively amortize.

Borrowers need to be explicitly informed that by paying less than the interest accrual during any period, they are increasing the total debt obligation on their loan. Moreover, they need to be informed of any debt that has the potential to exceed the value of the underlying asset which secures the loan. Some consumers are assuming these debts based on their assessment of their ability to pay the initial monthly payments, which is not an adequate measure of the risk or obligation of the loan. Consumers need to be fully apprised of the potential negative amortization of the lower payment options or any other mortgage structure which allows them to assume more debt than the dwelling is worth.

Q104: What guidance should the Federal Reserve provide to ensure the disclosures are clear and conspicuous?

At the time of application for a loan, consumers should be provided a separate disclosure in a manner that ensures consumers cannot help but see it and read it, which enumerates the additional risks that loans that have the potential to exceed the value of the underlying property have for consumers. It should include clear language that states that if the debt exceeds the value of the property, the borrower will still owe the lender after the property is sold. The disclosure should be provided early enough in the credit process so that a consumer can still change his or her mind. It is insufficient merely to provide this disclosure at the closing table, or even three days prior to closing -- it should also be provided when the consumer initially applies for the loan.

Q105: When should disclosures be provided to consumers?

Separate disclosures should be provided both at application for any mortgages containing these features, as well as three days before and at the time of closing, for purchase mortgages, that clearly describe the risk of any loan or loans which have the potential for borrowers to owe more in debt than the dwelling they are borrowing against is worth.