Testimony of Patricia A. McCoy[†] before Hearings by the Board of Governors of the Federal Reserve System on Home Equity Loans, Atlanta, Georgia July 11, 2006

Thank you for inviting me to testify before you today on federal home mortgage disclosures. In recent years, rising mortgage debt loads of ordinary homeowners have received widespread attention and concern. Policymakers exhort consumers to minimize their cost of credit by comparison-shopping for home mortgages. But these calls for comparison-shopping ignore the fact that certain consumers – specifically, individuals with poor credit – face informational barriers that make meaningful comparison-shopping for mortgages nearly impossible. In view of these barriers, it is not at all surprising, as Dean Edward Rubin noted fifteen years ago, that shopping for credit "remains extremely limited – limited to the same upscale consumers who would manage perfectly well without benefit of legislation."[1]

The Truth in Lending Act and the Real Estate Settlement Procedures Act were both enacted to remove informational barriers to consumer search for residential mortgages.[2] Both statutes were enacted in days of old when the only conventional mortgage market was the prime market and home mortgages were limited to customers with strong credit records. The U.S. system of mandatory mortgage disclosures was designed for the old world of prime loans.

Since then, over the past two decades, the U.S. residential mortgage market has undergone rapid change. The market has evolved from strictly a prime market based on average-cost pricing (in which comparable mortgages have roughly one price) to a dual market offering both prime loans and subprime loans[3] based on risk-based pricing (in which the price for a given mortgage varies according to the borrower's risk).

However well traditional mortgage disclosures work in the prime market, the traditional rules break down in the world of risk-based pricing. The traditional rules were predicated on unique conditions in the prime market that do not hold in the subprime world. Subprime advertisements are tantamount to affirmative misrepresentations for most customers with blemished credit because lenders generally tout their best rates alone. Subprime lenders do not provide firm price quotes to customers before application and often not until closing, when it is too late to shop. Similarly, lock-in commitments, which are customary in the prime market, are rarely ever seen in the subprime world.

If meaningful comparison-shopping means anything, it means the ability to obtain firm apples-to-apples price quotes from multiple lenders without having to pay large, nonrefundable fees. Unfortunately, most subprime customers lack that ability. Instead, under current federal

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1 Edward L. Rubin, *Legislative Methodology: Some Lessons from the Truth-in-Lending Act*, 80 GEO. L.J. 233, 236 (1991-1992).

2 Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (1968); Real Estate Settlement Procedures Act, Pub. L. No. 93-533, 88 Stat. 1724 (1974); *see* Rubin, *supra* note 1, at 233.

3 Subprime loans are designed for borrowers with weaker credit and for borrowers who want low-documentation or no-documentation loans.

disclosure laws, subprime lenders can entice customers with rosy prices that are not available to weaker borrowers, promise them a higher price after they pay a hefty application fee, then raise the price again at closing, often with no advance notice. Under these circumstances, our broken system of federal mortgage disclosures impedes meaningful comparison-shopping and efficient subprime prices.

This state of affairs is not inevitable, however. As I will explain, subprime lenders and mortgage brokers have the technology and information they need *right now* to provide firm price quotes to consumers at minimal cost without extracting large application fees. Requiring them to use this technology to provide firm quotes would revolutionize consumer search in the subprime world. Similarly, minor changes to federal regulations governing subprime mortgage advertising would help alleviate the current state of rampant misrepresentations and misleading omissions in the subprime market. Advance disclosure of legitimate changes in loan terms at least a week before closing would further constrain bait-and-switch tactics at closing. Finally, revamped disclosure rules for variable-rate loans would aid consumer understanding of the most important risk presented by these loans, which is the worst case payment scenario.

My testimony is organized as follows. In Part I, I describe how the residential mortgage market has evolved from a prime market based on average-cost pricing to a dual market that also offers risk-based pricing. Part II provides a thumbnail description of the relevant provisions of federal mortgage disclosure laws. In Part III, I explain why the market dynamics of the subprime market cause traditional disclosure rules to break down. Part IV sets forth my proposals for reforming the disclosure rules to permit meaningful comparison-shopping in the subprime market.

I. The Old World And The New

In the 1960s and 1970s, when our current federal mortgage disclosure laws were enacted, the mortgage world was a different place. Individuals with poor credit were systematically excluded from conventional credit, lenders gave free price quotes, lock-in commitments were common, and mortgages with similar features went for approximately the same price. Congress designed federal disclosure laws with these market conditions in mind. In later decades, when market conditions evolved and credit became available to weaker borrowers at higher, risk-adjusted prices, the disclosure laws began to show their age.

A. The Old World Of Average-Cost Pricing

Before about 1990, mortgage lenders generally restricted home loans to prime borrowers, who are individuals with strong credit. Lenders rationed credit because demand exceeded supply. People who were observationally risky could not get conventional home mortgages.[4] Furthermore, many lenders stereotyped blacks, Hispanics, and members of other minority groups as inherently risky and categorically denied them loans.

[4] *See* Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981).

In this market, known as the "prime market," lenders price mortgages based on average cost. Prime borrowers have differences in credit risk (albeit narrow ones) and some of them are riskier than others. Lenders do not adjust the price for prime mortgages, however, based on these differences in risk. Instead, under average-cost pricing, a lender aggregates individual credit risks, averages them, and computes one price for all of its prime borrowers based on the average. As a result, for any given loan product, such as a 30-year fixed-rate mortgage with no points, a lender will charge all of its prime borrowers the identical price.

Under average-cost pricing, not every loan applicant will receive a loan. Instead, average-cost pricing amounts to a pass-fail system in which the outcome depends on whether the customer qualifies for the loan. If she qualifies, she receives the standard price. If she does not, the lender denies the loan outright.[5]

Average-cost pricing has two important implications for efficient pricing. First, prices for prime mortgages with comparable features are highly competitive and trade within a relatively narrow band. Similar mortgages have roughly homogeneous prices. Second, this price competition give prime borrowers leverage to demand concessions from lenders in the form of lock-in commitments, interest rate reductions in exchange for points, and the general absence of prepayment penalties.

B. The New World Of "Risk-Based" Pricing

Starting in the late 1970s and continuing through the early 1990s, a confluence of legal, technological, and market forces caused the residential mortgage market in the United States to undergo wholesale transformation.[6] These changes resulted in the emergence of the subprime mortgage market, which charges higher interest rates and fees and is designed for borrowers with poor credit. The subprime market charges different borrowers different prices for the same product, ostensibly based on their individual risk.

In theory, such "risk-based pricing" pigeonholes borrowers according to risk and calibrates prices accordingly. This leads to multiple prices for the same loan. The price of the loan goes up as the borrower's creditworthiness goes down.[7] A subprime lender, for example, may differentiate prices according to a complex matrix of factors, including credit scores, loan-to-value ratios, debt ratios, and prepayment risk.

At this point, it is important to add a caveat. In reality, "risk-based pricing" is a misnomer. "Risk-based pricing" implies that pricing is accurately calibrated to credit risk. In reality, prices in the subprime market are only partly based on differences in borrowers' risk. Other factors, including mortgage broker compensation, discrimination, and rent-seeking can and

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[5] *See* Arnold S. Kling, *Get Set for Loan-Level Pricing*, 1997 MORTGAGE MARKET TRENDS 17, 17-18, 20 (Freddie Mac 1997), available at www.freddiemac.com/finance/smm/july97/pdfs/kling.pdf.

[6] *See* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1273-1280 (2002).

[7] *See* Kling, *supra* note 5, at 17-18.

do push up subprime prices.[8] This phenomenon has resulted in well-publicized abuses in the subprime market.[9] Accordingly, when I use the term "risk-based pricing," I use it in its weak sense to refer to individualized pricing that may or may not be accurately tailored to a borrower's risk.

II. Federal Law Governing Price Revelation In the Home Mortgage Markets

In thinking about whether comparison-shopping is feasible in the subprime market, it is necessary to analyze how prices are revealed to consumers. In both the prime and subprime markets, price revelation is not entirely relegated to market forces. Instead, price revelation is the result of interaction between market forces and federal (and state) disclosure laws. Such interaction varies, often dramatically, depending on whether a consumer is shopping in the world of average-cost or risk-based pricing.

My focus is on federal disclosure laws governing closed-end residential mortgages (other than reverse mortgages),[10] a product that is often associated with subprime lending abuses. Two major federal disclosure laws – the Truth in Lending Act[11] (TILA) and the Real Estate Settlement Procedures Act[12] (RESPA) – mandate disclosures about the costs associated with most residential mortgages. RESPA requires standardized disclosures about the settlement costs of residential mortgages. TILA requires lenders to disclose the cost of credit in two standardized formats, the finance charge and the annual percentage rate (APR). The finance charge seeks to capture the total dollar cost that a borrower will pay for credit, including interest payments, points, origination fees, and private mortgage insurance. The APR provides a different metric of the total cost of credit by converting the finance charge into an effective interest rate per year.[13] The Federal Reserve Board promulgates the regulations implementing TILA, while the Department of Housing and Urban Development (HUD) implements RESPA.

A. Regulation Of Price Revelation In General Advertising

Often, consumers shop for products by comparing prices in general advertisements. Neither TILA nor RESPA requires lenders to advertise prices. Consequently, when lenders advertise the cost of credit, they do so voluntarily.

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[8] *See, e.g.*, Howard Lax, Michael Manti, Paul Raca, & Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUSING POL'Y DEBATE 533, 565 (2004) (finding that "some borrowers end up with subprime loans for reasons other than risk" and calling that finding "disturbing").

[9] *See, e.g.,* Engel & McCoy, *supra* note 6, at 1259-70, 1280-98.

[10] Closed-end mortgages are loans that finance fixed amounts of principal. Open-end mortgages, in contrast, are lines of credit in which the amount financed varies between zero and a dollar limit stated in the loan contract, at the borrower's option.

[11] 15 U.S.C. §§ 1601–1693(c). One section of TILA, the Home Ownership and Equity Protection Act or HOEPA, mandates stricter disclosures for the most expensive subprime loans. For a description of HOEPA's disclosure rules, see notes 49-53 *infra* and accompanying text.

[12] 12 U.S.C. §§ 2601–2617.

[13] *See generally* Department of Housing and Urban Development & Federal Reserve Board, Joint Report to Congress, *Truth in Lending Act and the Real Estate Procedures Act*, Executive Summary at I (1998) [hereinafter HUD-Fed Joint Report], *available at* www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

TILA lightly regulates the content of loan advertisements, while RESPA does not regulate advertisements at all. Two of TILA's provisions require lenders to make standardized disclosures whenever other price terms are advertised. Specifically, any advertisement that states an interest rate must state the annual percentage rate. Written advertisements may also state a simple, periodic nominal interest rate to be applied to an unpaid balance so long as that rate is no more conspicuous than the APR.[14] Oral responses to consumer inquiries about rates for closed-end loans, in contrast, may *only* state the APR.[15] Finally, any advertisement that quotes any of four types of loan terms -- a down payment by percentage or amount, the amount of any monthly loan payment or finance charge, the number of payments, or the period of repayment -- must also state the APR, plus the terms of repayment and the amount or percentage of any down payment.[16]

Other provisions of TILA prohibit certain types of misrepresentations or misleading omissions in advertising.[17] Thus, lenders may not advertise specific credit terms, such as APRs or minimum down payments (such as "zero down payment" or "only 5% down") unless they actually offer those terms.[18] However, neither TILA nor its regulations require subprime lenders to offer their best, advertised terms to every customer. Indeed, the statute and the regulations do not even require lenders to provide disclaimers stating that availability depends on creditworthiness.

Advertisements featuring low introductory rates on variable-rate loans – known as "teaser rates" – raise other difficulties that TILA fails to fully resolve. Under TILA, an advertisement touting a teaser rate must state how long the teaser rate lasts and advise readers that the APR could rise after consummation.[19] However, nothing in TILA requires an ad to "describe the rate increase, its limits, or how it would affect the payment schedule."[20] This allows lenders to entice borrowers with promises of low interest, without revealing how high their interest rate could go on the loan.

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[14] 15 U.S.C. § 1664(c); 12 C.F.R. § 226.24(b).

[15] 15 U.S.C. § 1665a; 12 C.F.R. § 226.26(b) (but creating an exception providing "that a simple annual rate or periodic rate also may be stated if it is applied to an unpaid balance"). *Cf.* 12 C.F.R. § 226.26(a) (governing open-end credit).

[16] 15 U.S.C. § 1664(d); 12 C.F.R. § 226.24(c); Official Staff Commentary to 12 C.F.R. § 226.24(c), 12 C.F.R. pt. 226, Supp. I, available at ecfr.gpoaccess.gov (hereinafter "Official Staff Commentary"). *Cf.* 12 C.F.R. § 226.16(d) (governing open-end home equity plans).

[17] One such provision states that when a lender advertises a loan in which the amount lent may exceed the fair market value of a principal residence that secures the loan (either in paper format or on the Internet), the lender must clearly and conspicuously state that the interest on any principal that exceeds the home's fair market value is not deductible for federal income tax purposes and advise consumers to consult a tax adviser. 15 U.S.C. § 1664(e); *see also id*. § 1638(a)(15), (b)(3). This provision does not take effect until twelve months after the date of publication of implementing regulations by the Federal Reserve Board, however. Pub. L. No. 109-8, 119 Stat. 23, Title XIII, § 1302(c) (2005). As of August 14, 2006, no such regulations had yet been implemented.

[18] 15 U.S.C. § 1662(2); 12 C.F.R. § 226.24(a). *Cf.* 12 C.F.R. § 226.16(a) (governing open-end credit).

[19] 15 U.S.C. § 1664(d); 12 C.F.R. § 226.24(c); Official Staff Commentary to 12 C.F.R. §§ 226.17(c), 226.24(b), (c).

[20] Official Staff Commentary to 12 C.F.R. § 226.24(c).

Other aspects of TILA regulation weaken the effect of even these few restrictions on home loan advertisements. For instance, there are "no specific rules for the format of the necessary [advertising] disclosures."[21] While advertising under TILA is supposed to be "clear and conspicuous," the spirit of that standard is often honored in the breach. In fact, the Official Staff Commentary to TILA's regulations advises that the "credit terms need not be printed in a certain type size nor need they appear in any particular place in the advertisement."[22] What is more, consumers cannot sue lenders or the publications that run their ads under TILA for advertising violations.[23] As a result, enforcement of TILA's advertising rules is weak or non-existent.

In sum, TILA's provisions on mortgage advertising are silent on two key issues that affect truth in advertising for subprime loans. First, TILA allows subprime lenders to tout their best rates, without disclaimers and regardless of the fact that numerous subprime customers will not qualify for those rates. Second, TILA permits lenders to dangle alluring teaser rates before consumers without notifying them how high their interest rates might go following the rate reset. Weak enforcement of TILA's few provisions on point increases the likelihood of misleading disclosures.

B. Subsequent Disclosures

In the course of shopping for credit, often consumers inquire into the terms of specific loans. For the most part, however, TILA and RESPA do not regulate disclosures in response to these consumer inquiries at or before the application stage.[24] When a loan officer or broker takes an application, for instance, he or she will usually make representations to the customer about the nominal interest rate, the loan product (*e.g.*, fixed, adjustable rate, hybrid, interest-only), and the loan term (*e.g.,* thirty years) by entering that information on the application form. These entries are not binding, however, under TILA or RESPA. The lender is free, at least under those two statutes, to change the loan product or the final terms of the loan for any reason after taking the loan application so long as the lender satisfies all subsequent disclosure requirements. Entries on the application form only become binding if the borrower and the lender privately negotiate a lock-in commitment, which is common in the prime market but not in the subprime market.

After a consumer submits a loan application, TILA and RESPA do impose additional disclosure requirements.[25] The content of those disclosures and their timing vary depending on the loan product and the statute, as I now discuss.

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21 Official Staff Commentary to 12 C.F.R. § 226.24.

22 *Id.*; 12 C.F.R. § 226.17(a)(1); Official Staff Commentary to 12 C.F.R. § 226.17(a). *Cf.* 12 C.F.R. §§ 226.5(a)(1), 226.16(b) (governing open-end credit).

23 Jordan v. Montgomery Ward & Co., 442 F.2d 78 (8th Cir.), *cert. denied*, 404 U.S. 870 (1971); Fidelity Mortgage Corp. v. Seattle Times Co., 304 F. Supp.2d 1270 (W.D. Wash. 2004); *see* 15 U.S.C. §§ 1640(a), 1665.

24 The one exception concerns disclosures about variable-rate features, which may require earlier disclosures under TILA. *See* notes 33-44 *infra* and accompanying text.

25 These requirements of TILA are subject to criminal and civil government enforcement. 15 U.S.C. §§ 1607, 1611. Willful and knowing violations are punishable by a fine of up to $5000 and imprisonment for up to one year. *Id.* § 1611. In addition, borrowers can sue for actual damages, statutory damages, and attorneys' fees, either individually or in class actions, for violations of TILA's loan-specific provisions. 15 U.S.C. § 1640(a).

1. The Truth In Lending Act

a. In General

Except for variable-rate disclosures, TILA does not require disclosures about loans that elicit consumer inquiries until sometime after application. Then, TILA requires written disclosure of the APR, the amount financed, the finance charge, and certain other features of the loan.[26] The deadline for these disclosures depends on the loan type. For first-lien, closed-end purchase money mortgages (*i.e.*, loans used to buy homes) that are governed by RESPA,[27] the lender normally must deliver or mail good faith estimates of these TILA disclosures within three business days after receiving a written loan application.[28] For most closed-end refinance mortgages, however, a lender can postpone making the TILA disclosures until any time "before the credit is extended,"[29] which the Federal Reserve Board construes to mean any time "before

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In certain closed-end, cash-out refinance home mortgages, borrowers can rescind their loan transactions for any reason within three business days following consummation of the loan or the delivery of correct TILA disclosures, whichever is later. 15 U.S.C. § 1635(a). At closing, lenders must provide such borrowers with written notice of the right to rescind under TILA. 15 U.S.C. § 1635(a); 12 C.F.R. §§ 226.5(a), 226.23(b). In addition, any borrowers with closed-end, cash-out, home refinance loans who receive inaccurate, material disclosures concerning the APR, any variable-rate features, the finance charge, the amount financed, total payments, or the payment schedule (or who never received those disclosures), can rescind their mortgages for up to three years following consummation. 15 U.S.C. §§ 1602(u), 1635(e)-(f); *see generally* ELIZABETH RENUART & KATHLEEN KEEST, TRUTH IN LENDING ch. 6, § 6.4.2.5 (5th ed. 2003 & Supps.). When a borrower qualifies for this extended right of rescission, the rescission period usually lasts until the sale of the property or three years after consummation of the loan, whichever is earlier. 15 U.S.C. § 1635(f). However, in the five states that have adopted TILA as a matter of state law and thus have an exemption from the federal act – Connecticut, Massachusetts, Maine, Oklahoma, and Wyoming – borrowers can arguably rescind at any time, not just within three years, when defending themselves against foreclosure or a collection suit if the state's law recognizes the doctrine of recoupment. *See* Renuart & Keest, *supra*, §§ 2.6.1, 2.6.2, 6.2.10.

[26] 15 U.S.C. § 1638(a)(2)(A), (a)(3)-(a)(4); 12 C.F.R. § 226.18(b)-(r); Official Staff Commentary to 12 C.F.R. § 226.18. The required disclosures include, but are not limited to, descriptions of the payment schedule, any demand feature, the total sale price, the presence of a prepayment penalty, late fees, the security interest, and certain other fees. 15 U.S.C. § 1638(a)(5)-(a)(15); 12 C.F.R. § 226.18. For loans not subject to RESPA, the lender must also provide a separate written itemization of the amount financed. 12 C.F.R. § 226.18(c)(1); Official Staff Commentary to 12 C.F.R. § 226.18(c).

[27] 15 U.S.C. § 1638(b)(2); 12 C.F.R. §§ 226.2(a)(19), (a)(24); Official Staff Commentary to 12 C.F.R. § 226.2(a)(24), *as amended by* 63 Fed. Reg. 16669 (Apr. 6, 1998). RESPA applies to "federally related mortgage loans," which include loans (including purchase money and refinance loans) that have a federal nexus (defined broadly) and are secured by residential real estate designed principally for the occupancy of one to four families. 15 U.S.C. §§ 2602(1), 2603(a), 2604(a), 2605(a), 2607, 2608(a), 2609(a)-(c), 2610; 24 C.F.R. § 3500.5.

[28] 15 U.S.C. § 1638(b)(2); 12 C.F.R. §§ 226.17(c)(2), 226.19(a)(1); Official Staff Commentary to 12 C.F.R. § 226.19(a)(1)-(a)(2). Alternatively, if the creditor determines within three days after receipt of a written application that the application will be turned down on the terms requested, no disclosures are necessary. Official Staff Commentary to 12 C.F.R. § 226.19(a)(1)-4.

In the rare event that the borrower consummates the loan before the three-day period elapses, the lender must make the disclosures before consummation. 12 C.F.R. § 226.19(a)(1). This could occur if a lender or broker fraudulently induced a consumer to sign a loan note unknowingly before the three-day period was up.

[29] 15 U.S.C. § 1638(b)(1). High-cost, closed-end refinance home loans that are governed by the Home Ownership Equity and Protection Act (HOEPA) are subject to more stringent timing requirements. *See* notes 49-53 *infra* and accompanying text.

consummation."[30] Thus, for most refinance mortgages, a lender can delay providing TILA disclosures until the closing, so long as the customer signs the TILA disclosures before signing the loan agreement.[31]

This loophole for refinance loans cobbles borrowers in the subprime market, where refinance loans have been rife with abuses.[32] Even for loans requiring disclosures within three business days after receipt of application, the borrower does not receive TILA disclosures before paying an application fee. These fees usually are non-refundable and cost several hundred dollars. Accordingly, unless a lender provides information mandated by TILA voluntarily before application, the customer must fork over several hundred dollars in order to learn the price of the loan.

The only time that lenders must provide individual disclosures under TILA before customers pay application fees are for variable-rate disclosures. When a customer is considering a closed-end variable-rate loan[33] secured by his or her principal residence, the creditor must supply him or her with a generic government handbook that provides an overview of how adjustable-rate mortgages work (quirkily known, after its acronym, as the "charm book").[34] The lender must also provide the customer with copious generic disclosures about every variable product in which the customer expresses an interest that, among other things, notifies the customer that he or she has inquired about a variable-rate loan.[35] A creditor who deals directly with the customer must furnish these disclosures whenever it provides the application form or before the customer pays a nonrefundable fee, whichever is earlier.[36] When a creditor solicits a loan application by phone or through an intermediary agent or broker, however, it may deliver the disclosures or put them in the mail no later than three business days following receipt of the application.[37]

While the timing rules for variable-rate disclosures represent a modest improvement, the content of those disclosures do not. The disclosures, twelve in number, range from a generic

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[30] 12 C.F.R. § 226.17(a). The regulation defines "consummation" as "the time that a consumer becomes contractually obligated on a credit transaction" under state law. 12 C.F.R. § 226.2(a)(13); Official Staff Commentary to 12 C.F.R. § 226.2(a)(13)-1.

[31] "Theoretically, at least, disclosures could be given one second or thirty days *before* consummation without violating this requirement." Renuart & Keest, *supra* note 25, at 171 (emphasis in original).

[32] *See* Engel & McCoy, *supra* note 6, at 1263, 1275, 1279 n.104, 1282 & n. 118.

[33] This testimony uses "variable-rate" and "adjustable-rate" interchangeably.

[34] FEDERAL RESERVE BOARD, CONSUMER HANDBOOK ON ADJUSTABLE RATES MORTGAGES (ARM) (May 2005), available at www.federalreserve.gov/Pubs/arms/armstext_cover2005.pdf. Alternatively, the lender may provide the borrower with a "suitable substitute" to the charm book. 12 C.F.R. § 226.19(b)(1); Official Staff Commentary to 12 C.F.R. § 226.19(b)(1)-1.

[35] 12 C.F.R. § 226.19(b); Official Staff Commentary to 12 C.F.R. § 226.19(b)(2); *compare* 12 C.F.R. § 226.18(f). The disclosure rules in 12 C.F.R. § 226.19(b) only apply to closed-end variable rate home-secured loans with terms of over one year.

[36] 12 C.F.R. § 226.19(b).

[37] *Id.* For discussion of when a mortgage broker qualifies as an "intermediary agent or broker" for purposes of this provision, see Official Staff Commentary to 12 C.F.R. § 226.19(b)-3. If a mortgage broker does sufficient business with the creditor, the broker is no longer an "intermediary agent or broker," requiring the creditor to treat all applications solicited by that broker as applications made directly to the creditor. *See id.*

explanation of the index and the margin to obscure disclosures about the potential payment shock once the interest rate resets, and amount to serious information overload.[38] Furthermore, some courts have construed TILA to deny statutory damages liability for failing to give the variable-rate disclosures.[39]

Perhaps as a consequence of this case law, one major consumer advocacy organization reports that "[f]ew of our clients ever get these initial disclosures."[40] At the closing, the final TILA disclosure on point simply states that "[y]our loan contains a variable-rate feature. Disclosures about the variable-rate feature have been provided to you earlier." Consequently, if the creditor failed to deliver the initial variable-rate disclosures, the consumer will not have received disclosure of the maximum payment, the maximum interest rate, and the index used.

The variable-rate disclosure of greatest interest to most consumers is the worst case payment scenario under the loan – *i.e.,* how high their monthly principal and interest payments could go if the loan hits its interest rate cap. Presumably consumers would like to know the actual dollar amount of their highest possible monthly payment. Instead, TILA allows lenders to provide a hypothetical involving payment shock on a $10,000 mortgage and let the borrowers do the math.[41] Alternatively, lenders may provide a historical example, again based on a $10,000 mortgage, explaining how high the payments would have gone under the terms of that loan based on the historical high for the past fifteen years.[42] Lenders cling to the $10,000 hypotheticals, which are arcane in the extreme, precisely because many consumers, particularly vulnerable ones, cannot calculate the payment shock for variable-rate mortgages.[43] The $10,000 hypotheticals are so out-of-date that the *New York Times* recently advised borrowers with exotic

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[38] 12 C.F.R. § 226.19(b).

[39] *See* Brown v. Payday Check Advance, 202 F.3d 987 (7th Cir. 2000); Baker v. Sunny Chevrolet, 349 F.3d 862 (6th Cir. 2003); Renuart & Keest, *supra* note 25, § 8.6.5.3.

[40] Letter from the National Consumer Law Center to Vice Chairman Roger W. Ferguson, Jr., and Governors Susan Schmidt Bies, Donald L. Kohn, and Mark W. Olson of the Federal Reserve Board 2 (Jan. 17, 2006).

[41] In the words of the regulation in question, the lender may provide at its option the "maximum interest rate and payment for a $ 10,000 loan originated at the initial interest rate (index value plus margin, adjusted by the amount of any discount or premium) in effect as of an identified month and year for the loan program disclosure assuming the maximum periodic increases in rates and payments under the program," along with an "explanation of how the consumer may calculate the payments for the loan amount to be borrowed based on" the $10,000 hypothetical. 12 C.F.R. § 226.19(b)(2)(viii)(B), (ix)(B).

[42] The relevant regulation states that the lender may alternatively disclose a "historical example, based on a $10,000 loan amount, illustrating how payments and the loan balance would have been affected by interest rate changes implemented according to the terms of the loan program disclosure. The example shall reflect the most recent 15 years of index values." 12 C.F.R. § 226.19(b)(2)(viii)(A). Lenders must also explain how consumers can apply the historical example to calculate the maximum payment on their own loans. 12 C.F.R. § 226.19(b)(2)(ix)(A).

[43] A 2004 study by the Consumer Federation of America found that over one-third of all Americans surveyed who preferred ARMs could not estimate the payment increase. The percentages were even worse for young adults age 18 to 24 (46%), Hispanics and blacks (43%), people with incomes under $25,000 (44%), and people without a high school degree (50%). *See* Consumer Federation of America, "Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages," 3 (press release July 26, 2004), available at www.consumerfederation.org/releases.cfm#Consumer%20Literacy. *See also infra* notes- 94-95 and accompanying text.

adjustable-rate mortgages to figure out their maximum monthly payments by consulting "mortgage payment calculators on the Web"[44] – *not* their TILA disclosures.

If initial disclosures, whether variable-rate or otherwise, turn out to be inaccurate, TILA sometimes requires redisclosure. If the lender denies the original application and the consumer then amends it, the amendment is treated as a new application and the three-day period starts anew.[45] If a variable-rate feature is added to the loan, new disclosures are necessary, but only immediately before consummation.[46] Finally, if the actual APR at closing varies from the APR that was originally disclosed by more than 1/8 of one percent, usually the creditor must disclose the actual APR by the settlement or consummation.[47] These last two rules place applicants who lack lock-in commitments at the mercy of lenders, who can change the loan terms and even the loan products they applied for behind the scenes, then spring the new loan terms on them at closing.[48]

b. <u>High-Cost Loans Governed By The Home Ownership And Equity Protection Act</u>

Under the Home Ownership and Equity Protection Act (HOEPA),[49] federal disclosure law imposes stricter disclosure requirements on certain high-cost residential mortgages. HOEPA applies to most high-cost, closed-end, refinance residential mortgages. HOEPA defines high-cost loans as loans with APRs of at least eight percent over the yield on Treasury securities of comparable maturity for first-lien loans (or ten percent for subordinate-lien loans) or total points and fees exceeding eight percent of the total loan amount or $400 (indexed annually), whichever is greater.[50]

These so-called "HOEPA loans" requires added disclosures at least three days before closing.[51] The advance disclosures include the final APR, the amount of individual monthly payments, the amount of any balloon payment, the principal borrowed, and fees for any credit

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44 Damon Darlin, *Keep Eyes Fixed on Your Variable-Rate Mortgage*, N.Y. TIMES, July 15, 2006.

45 Official Staff Commentary to 12 C.F.R. § 226.19(a)(1)-4.

46 Official Staff Commentary to 12 C.F.R. § 226.17(f)-2. *See* notes 38-42 *supra* and accompanying text for the content of these disclosures.

47 15 U.S.C. § 1638(b)(2); 12 C.F.R. §§ 226.17(f), 226.19(a)(2), 226.22(a); Official Staff Commentary to 12 C.F.R. § 226.17(f)-1(i)(A).

48 *See* HUD-Fed Joint Report, *supra* note 13, at 43; Elizabeth Renuart, *An Overview of the Predatory Mortgage Lending Process*, 15 HOUSING POL'Y DEBATE 467, 483 (2004), available at www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1503_Renuart.pdf.

49 15 U.S.C. §§ 1601 et seq.

50 15 U.S.C. § 1602(w), (aa)(1)–(4); 12 C.F.R. § 226.32(a), (b)(1). HOEPA does not apply to high-cost reverse mortgages. 15 U.S.C. § 1602(aa)(1), (bb); 12 C.F.R. § 226.32(a)(2). The federal government has civil enforcement powers for violations of HOEPA. In addition, willful and knowing violations of HOEPA are subject to criminal prosecution. 15 U.S.C. § 1611; *see* note 25 *supra.* HOEPA affords borrowers the same private right of action available under TILA. 15 U.S.C. § 1640(a); *see* note 25 *supra.* In addition to TILA's standard remedies, borrowers who recover under HOEPA have a right to special enhanced damages consisting of all finance charges and fees paid by the borrower, 15 U.S.C. § 1640(a)(4), plus expanded rights of rescission. 15 U.S.C. §§ 1635, 1639(j); 12 C.F.R. § 226.23(a)(3). *See generally* Renuart & Keest, *supra* note 25, §§ 9.4.9, 9.6.

51 15 U.S.C. §§ 1601, 1602(aa), 1639(a)–(b).

insurance or debt-cancellation policy. Lenders must notify borrowers in writing that they could lose their homes upon default. Similarly, borrowers must be advised that they do not have to accept the loans just because they submitted loan applications or received disclosures. For variable-rate HOEPA loans, lenders must also advise borrowers that their interest rates and monthly payments could increase and also provide them with their maximum monthly payment if the loan becomes fully indexed.[52]

The disclosure requirements for HOEPA loans represent marginal improvement over TILA's woefully inadequate disclosures for refinance loans. However, HOEPA does not cover subprime purchase money mortgages. As a result, and because HOEPA's triggers are set so high for refinance loans, HOEPA disclosures apply at most to five percent of subprime first-lien home loans.[53] It is similarly necessary to ask whether a three-day warning is enough to dissuade a cash-strapped borrower who is desperate enough to pay the interest rates on HOEPA loans.

2. Real Estate Settlement Procedures Act

RESPA requires lenders who make federally related mortgage loans[54] to provide borrowers with disclosures about their closing costs at two different stages in the mortgage process. First, within three business days after application, the lender or mortgage broker must provide an applicant with a good-faith estimate of the settlement costs (GFE) and certain other disclosures concerning settlement costs and servicing.[55] This three-day period usually coincides with the three-day period for TILA disclosures (which apply to purchase money mortgages only).[56] Because the GFE contains only certain pricing terms – those related to origination fees – and does not list the APR, the payment schedule, the prepayment penalty, etc., it does not remedy the lack of mandatory three-day TILA disclosures for most home refinance loans.[57]

Later, at the closing for all federally related mortgage loans (including refinance loans and reverse mortgages), the settlement agent must furnish the borrower with a HUD-1 settlement statement listing the actual settlement costs paid at closing, plus an initial escrow statement.[58] Borrowers have the right to inspect the HUD-1 upon request on the day before the closing.[59] Like the GFE, HUD-1s only disclose origination costs and not the APR or certain other key

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[52] 15 U.S.C. § 1639(a); 12 C.F.R. § 226.32(c); *see generally* Renuart & Keest, *supra* note 25, ch. 9. Lenders must also advise HOEPA borrowers in advance of the loan closing that the total amount borrowed may be substantially higher than the amount requested due to the financing of insurance, points, and fees. *See* Federal Reserve System, Truth in Lending, 66 Fed. Reg. 65,604, 65,610-11 (Dec. 20, 2001) (codified at 12 C.F.R. § 226.32(c)(5)). "The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate." Dep't of the Treasury et al., Interagency Guidance on Nontraditional Mortgage Products: Proposed guidance with request for comment, 70 Fed. Reg. 77249, 77252 n.5 (Dec. 29, 2005).

[53] *See* Federal Reserve System, Truth in Lending, 66 Fed. Reg. 65,604, 65,606-10 (Dec. 20, 2001).

[54] For discussion of RESPA's exact coverage, see note 27 *supra.*

[55] 15 U.S.C. §§ 2603-2605(a); 24 C.F.R. §§ 3500.6(a)(1), 3500.7, 3500.21(b); *id.* pt. 3500 app. C.

[56] *See* Renuart & Keest, *supra* note 25, at 172 n.244.

[57] *See* notes 29-31 *supra* and accompanying text.

[58] 24 C.F.R. § 3500.8, *id.* pt. 3500 app. A. The lender may also need to make servicing disclosures at closing. *Id.* § 3500.21(c), pt. 3500 app. MS-1.

[59] 24 C.F.R. § 3500.10(a).

disclosures mandated by TILA. Accordingly, lenders who extend home refinance loans (other than the limited set of HOEPA loans) do not have to disclose the APR until the date of closing.

Under RESPA, injured borrowers have little relief for false disclosures other than to petition the Department of Housing and Urban Development for government enforcement.[60] Specifically, borrowers cannot recover damages unless they can prove that lenders: (1) failed to inform them that their loans could be transferred,[61] (2) received illegal kickbacks as defined by RESPA,[62] or (3) steered them to title companies.[63] Lenders have no liability to borrowers under RESPA for errors in GFEs or HUD-1 settlement statements, which dampens their motives to ensure accuracy.[64]

RESPA's timing rules have the same faults as TILA's timing rules. Lenders do not have to provide GFEs until after consumers have paid a nonrefundable application fee. And while borrowers can request HUD-1s the day before closing, nothing requires lenders to notify borrowers of that right and borrowers are generally ignorant of it.[65] Furthermore, GFEs may have scant resemblance to actual closing costs because lenders are allowed to provide meaningless estimated ranges and do not face suit for inaccurate GFEs.[66] This problem is of particular concern in the subprime market, where settlement costs range from high to plainly exorbitant.[67] As a result, GFEs are not helpful to consumers for comparison-shopping.

In sum, federal disclosure laws are problematic for subprime mortgage customers in four key respects. First, federal law does not require accurate disclosures of the cost of subprime loans before a customer pays a nonrefundable application fee (except for certain variable-rate disclosures). Indeed, under TILA, lenders can advertise their best rates, even if those rates only apply to sterling customers. Second, TILA's variable-rate disclosures are too complex and obscure the most critical information for customers, which is their worst case payment scenario. Third, for most closed-end home refinance loans other than HOEPA loans, lenders can legally postpone making TILA disclosures on the APR and other key price terms until the date of closing. Lastly, binding cost disclosures are usually not required until the closing (except for borrowers who have HOEPA loans or request their HUD-1s the day before), which means that lenders can change the loan terms at the eleventh hour with no advance notice to borrowers. Consequently, when lenders provide accurate cost information early enough in the process to allow consumers to do meaningful comparison-shopping without paying an application fee, they do so voluntarily, not because they are required to by law.

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[60] Agency enforcement authority for RESPA is vested in HUD. 12 U.S.C. §§ 2602(6), 2617(a).

[61] 12 U.S.C. § 2605(f) (authorizing actual damages, statutory damages, costs, and attorneys' fees).

[62] *Id.* § 2607 (authorizing treble damages and attorneys' fees).

[63] *Id.* § 2608. The defendant is liable for up to three times the fee for the title insurance. *Id.* § 2608(b).

[64] *See* HUD-Fed Joint Report, *supra* note 13, Executive Summary at XIX, 21.

[65] *See id.* at 43.

[66] *See id.* at XI. In a survey of GFEs, Mark Shroder concluded that numerous GFEs were off by "a fair amount" and that some borrowers received "large underestimates." MARK SHRODER, THE VALUE OF THE SUNSHINE CURE: EFFICACY OF THE RESPA DISCLOSURE STRATEGY 12 (HUD, Working Paper, Apr. 2000).

[67] *See, e.g.*, Engel & McCoy, *supra* note 6, at 1266-67 & n.30; Renuart, *supra* note 48, at 467, 475-76, 482; Shroder, *supra* note 66, at 14-5, tbl. 4; Patricia Sturdevant & William J. Brennan, Jr., *A Catalogue of Predatory Lending Practices*, 5 CONSUMER ADVOC. 4 (1999).

III. Consumer Search And Price Revelation: The Effect of Market Forces

As the previous discussion suggests, federal disclosure laws do not ensure that consumers get accurate information sufficiently early in the mortgage process to permit low-cost, meaningful comparison-shopping. To the extent that that occurs, it is due to market forces, not federal disclosure law.

A. Search In The Prime Market

In the prime market, pricing is highly competitive, lenders market mortgages as commodities, and the market results in roughly homogeneous prices. Prime customers know that identical mortgages[68] go for about the same price. They also know that lenders with competitive rates will prominently advertise discounts. Consequently, consumers will gravitate toward lenders who post prices and gravitate away from lenders who do not. This gives prime lenders strong incentives to post accurate prices publicly in order to attract customers. Today, it is easy to comparison-shop for prime mortgages on the Internet, where standardized price information abounds.

These market forces mean that consumers do not have to pay application fees in order to get price quotes in the prime market. Rather, lenders reveal prices for free. Furthermore, because prices are highly competitive and mortgages are commodities, lenders have to offer consumers an added bonus to get them to apply. This gives consumers leverage to negotiate lock-in commitments and insist on buy downs on prices, in the form of interest rate reductions in exchange for points or other fees.

When TILA was enacted in 1968, the prime market was the *only* conventional mortgage market and that was the market that TILA was designed for.[69] There, market forces ensure that lenders reveal critical price terms -- including interest rates, lock-in commitments, and points -- upfront and for free. In tandem with those forces, TILA was designed to standardize voluntary price disclosures. TILA does this relatively effectively for consumers who are prime-eligible and shopping for prime loans.

To be sure, price revelation could stand improvement in the prime market. Problems with RESPA's timing rules and lack of private enforcement for good faith estimates make closing costs a continued problem. Hidden transaction costs can be substantial in residential loan transactions and can haunt customers at closing, either in the prime or subprime markets.[70] Furthermore, guaranteed closing cost packages are still uncommon even in the prime market,

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[68] Of course, mortgages with identical terms (such as a 30-year fixed mortgage or a 2/28 hybrid adjustable-rate mortgage) may carry different interest rates depending on the number of points. Each of those pricing structures is a separate product and is advertised as such.

[69] Pub. L. No. 90-321, Title I, 82 Stat. 146 (May 29, 1968).

[70] *See, e.g.,* Kenneth Harney, *Guaranteed closing costs are approaching*, DETROIT FREE PRESS, Oct. 9, 2005.

although some lenders do offer them (at least for settlement costs within the lender's control).[71] The prime market is sufficiently competitive and prime customers are sufficiently savvy, however, that closing cost abuses are less of a problem in the prime market than in the subprime market. Nevertheless, all home mortgage applicants – prime and subprime -- pay too much because of lack of transparency in closing costs, a problem which is especially bad with respect to yield spread premiums and applies to all closing costs in general.

B. Search In The Subprime Market

Consumer search is entirely different in the subprime world, where market forces impede meaningful comparison-shopping. In the subprime market, the assumptions that TILA was based on – lock-in commitments and free and early price revelation -- break down. Instead, subprime lenders do not reveal their prices until consumers pay to play.

In risk-based pricing, a lender cannot determine the actual price for a loan until the customer reveals information about his or her creditworthiness.[72] Today, lenders use the loan application process for that purpose. As a result, the subprime market requires a customer to apply for a loan, pay a nonrefundable application fee, and go through underwriting in order to learn the price. Even then, subprime lenders often do not reveal the true price until closing.

1. Lack Of Firm Price Quotes Before Application

In the prime market, consumers are able to obtain firm price quotes without charge on interest rates, APR, and points, by consulting advertisements or price lists posted by lenders. In the subprime market, this is virtually impossible. Subprime lenders treat their price lists (known as "rate sheets") as proprietary secrets. Similarly, subprime advertisements usually tout only one price – the lender's best price – rather than the full range of prices charged to weaker borrowers.

In the subprime market, lenders use their own internal rate sheets to determine what price to charge a given borrower for a given loan. A subprime rate sheet is a grid containing different prices for a given loan. The price will vary according to a borrower's credit score, down payment (expressed in terms of a loan-to-value or LTV ratio), and debt-to-income ratio. The rate sheet may also reflect price adjustments for inclusion of a prepayment penalty, yield spread premium, and other features of the loan transaction (Exhibit 1). This information would be useful to consumers in shopping for loans. Consumers cannot get this information, however, because subprime lenders protect rate sheets as proprietary secrets and only share them with their employees and mortgage brokers (see Exhibit 2, asterisk footnote). Nothing in federal disclosure law prohibits withholding the information on rate sheets from consumers.

Consequently, to comparison-shop before the application stage in subprime, consumers must rely on general advertisements or oral representations by mortgage brokers or loan officers. Even though subprime lenders and brokers keep rate sheets secret, that does not hinder them

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[71] *See, e.g.*, Amerisave, www.amerisave.com/why_amerisave/writingcosts.cfm (reviewed July 15, 2006); E-Loan, www.eloan.com/s/show/guarantee (reviewed July 15, 2006); Harney, *supra* note 70.

[72] *See* HUD-Fed Joint Report, *supra* note 13, at 40.

from running advertisements with price quotes. Indeed, it is a common practice for them to quote their *best price*, whether or not the loan applicant qualifies for it and often without disclaimers. In effect, this operates as an affirmative misstatement for consumers with weaker credit profiles and can induce them to apply for loans that turn out higher-priced at closing.[73]

Some advertisements and websites that quote low rates cater specifically to subprime borrowers. Exhibit 3, for instance, illustrates an Internet site that allows consumers to shop for mortgages based on their personal credit score. Here, a search on July 4, 2006, for a 30-year fixed-rate mortgage for a borrower with a weak credit score of 590 resulted in quotes ranging from 6.1 percent with 1.5 points to 6.5 percent with two points. That week, average rates on 30-year fixed-rate mortgages were 6.78 percent with 0.5 points,[74] which means that the rates quoted on the website appeared to be prime rates. Only if readers clicked on the link "More info" and scrolled down a long page would they find a disclaimer stating: "*Rate/APR and terms may vary based on the creditworthiness of the individual* **. . .**" Given this disclaimer, it is not clear why the website allowed consumers to type in low credit scores at all unless it was designed to give the misleading impression that a borrower with a 590 credit score would in fact receive the quoted prime rates.

In sum, subprime borrowers who do not qualify for a lender's best rates do not have the ability to obtain firm quotes before they apply for loans. Making matters worse, consumers with weak credit are likely to be misled by low, advertised subprime rates unless they actually qualify for those rates.

2. Lack Of Firm Price Quotes After Application

With the exception of HOEPA loans, TILA and RESPA normally do not require firm price disclosures until the date of closing. Neither statute regulates the price terms that a loan officer or broker may enter on the application form. Similarly, neither statute requires firm price terms to be disclosed within three business days after receipt of an application. Instead, if the disclosures on GFEs or preliminary TILA disclosures prove inaccurate, the only cure is accurate disclosure on the date of closing. By then, however, disclosure is too late. By closing, the average customer is psychologically invested in the loan and has too much riding on it – such as purchasing a house or refinancing unmanageable debts – to walk away from the closing.

These dynamics make the terms and prices of subprime loans a moving target. A lender or broker might direct a customer to apply for one type of loan at Price A – say, a fixed-rate loan – change the loan during underwriting to an adjustable-rate mortgage at Price B, and change the loan again at closing to something different, such as an interest-only ARM, at Price C.

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[73] *See* Michael Hudson, *Popular Mortgage Web Site Under Scrutiny*, WALL ST. J., July 12, 2006, D1 (describing lawsuit against Bankrate.com for allegedly ignoring "hundreds of complaints against mortgage lenders who fail to deliver the rates they advertise").

[74] Freddie Mac, Weekly Primary Mortgage Market Survey (week of June 29, 2006), available at www.freddiemac.com/dlink/html/PMMS/display/PMMSOutputYr.jsp (viewed July 15, 2006). For the week of July 6, 2006, average rates for 30-year fixed-rate mortgages rose slightly to 6.79% and 0.5 points.

The moving target problem is even worse in the case of refinance loans that are not governed by HOEPA, where lenders do not even need to provide three-day TILA disclosures and can wait until closing to make their first loan-specific disclosures about the loan's APR. The case of Lucy Brown is instructive.[75] In 1998, Ms. Brown applied for a fixed-rate refinance loan at a nominal interest rate of 10.75 percent. Her preliminary Truth in Lending Act disclosure stated an 11.013 percent APR and a finance charge of $189,903.90. The disclosure said that her loan had no variable rate feature or prepayment penalty. During underwriting, the lender rated Ms. Brown as an "A" grade borrower who presumably qualified for a prime-rate loan.

Nevertheless, with no advance notice, the lender presented Ms. Brown at closing with a high-fee variable-rate loan with a large prepayment penalty and an initial nominal interest rate of 11.25 percent. The final Truth in Lending Act disclosure, presented to her at closing, revealed that her APR had risen 27.64 percent to 14.085 percent and her Finance Charge had risen 38.56 percent to $263,133.60. If Ms. Brown had received a prime loan, it would have cost her substantially less: at the time, the average prime-rate fixed 30-year home mortgage carried a nominal interest rate of 7.00 percent and one point.

The mortgage broker's file on Ms. Brown contained four different loan applications, each for a loan on different terms. She only signed two of the applications and none was for the loan she ultimately got. The first application was for a fixed-rate loan with no stated interest rate. The second was for a fixed rate loan at 10.75 percent; the third was for a fixed-rate loan at 11.25 percent. The fourth was for a fixed-rate loan at 12.375 percent. Ultimately, Ms. Brown received none of those loans. Instead, she ended up with a variable-rate loan at 11.25 percent.

Sometimes lenders have legitimate reasons to change the loan terms during underwriting. For instance, the lender may decide that the applicant could not qualify for the loan requested, either on the face of the application or because the application was incomplete and subsequent facts revealed underwriting problems. Even when there are legitimate reasons to change the loan terms, however, that does not justify allowing lenders to wait until the closing to disclose the change in terms, as TILA and RESPA usually permit.

In other instances, lenders or brokers have underhanded motives for switching the loan terms and springing them on the borrower at closing. For instance, behind the scenes, brokers may negotiate a commission known as a yield spread premium in exchange for higher interest payments to the lender. In Ms. Brown's case, for instance, the lender paid the broker a $2373 yield spread premium as a reward for increasing the interest rate on the loan from 10.75 percent to 11.25 percent and for changing the loan from a fixed-rate loan to a riskier adjustable-rate loan with a large prepayment penalty. Before the closing, the broker did not tell Ms. Brown that it would receive a large yield spread premium in exchange for driving up the cost of her loan. In Ms. Brown's case, the result was bait-and-switch.

If customers could negotiate lock-in commitments with subprime lenders, they might be able to avoid the moving target problem. Subprime customers with weak credit, however, have

[75] The facts are real but the name has been changed to protect the identity of the borrower.

less leverage to insist on those commitments because lenders know these customers have fewer options and cannot qualify for prime credit. Subprime customers, moreover, tend to be less well-educated and less sophisticated about the mortgage market.[76] Subprime lenders, knowing that that they can usually delay firm price quotes until closing under TILA and RESPA, have no legal compunction to offer lock-in commitments. This leaves subprime borrowers vulnerable to nasty surprises at closing.

3. Problems With Variable-Rate Disclosures

In the past two years, two new types of adjustable-rate mortgages (ARMs) have cropped up in the subprime market: interest-only (I-O) ARMs and Option ARMs. These mortgages present substantially greater risks of payment shock than traditional ARMs. This heightened risk, especially to subprime borrowers, underscores the urgency of reforming variable-rate TILA disclosures.

In interest-only mortgages, borrowers only pay interest for an initial period of six months to five years. Once the introductory period expires, the borrowers' payments go up, often substantially, for up to four distinct reasons. First, the loan begins to amortize and thus borrowers start paying principal as well as interest. Second, the principal payments are higher than they would be under a fully amortizing loan because there are fewer years left to pay off the principal. Thus, in a thirty-year I-O ARM with a three-year introductory period, the principal will be paid off in twenty-seven years, not thirty. Third, if interest rates are rising, the variable rate on the loan will go up on the reset date. Finally, numerous I-O ARMs offer introductory teaser rates that are below the indexed rate. Accordingly, when the teaser rate expires and the rate resets, the interest rate could jump higher than it would from an indexed rate.[77]

Option ARMS are cousins of I-O ARMs and potentially even riskier. During the introductory period of an option ARM, the borrower can choose among four payment options: accelerated amortization of principal (over fifteen years), normal amortization (over thirty years), interest-only, or a low minimum payment that does not even pay off the interest due that month. If a borrower opts for the minimum payment – as up to seventy percent of Option ARM borrowers do[78] -- the unpaid interest will be added to principal, causing the loan balance to grow.[79] This negative amortization makes the initial monthly payments enticing. Once the introductory period expires, however, the borrower must start making regular principal and

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[76] *See* Lax et al., *supra* note 8, at 544-56.

[77] *See, e.g.*, Christopher L. Cagan, Mortgage Payment Reset: The Rumor and the Reality 1, 17, 25 (Feb. 8, 2006), available at www.firstamres.com/pdf/MPR_White_Paper_FINAL.pdf; Mortgage Bankers Ass'n, Housing and Mortgage Markets: An Analysis 55 (MBA Research Monograph Series No. 1, Sept. 6, 2005), available at www.mortgagebankers.org/files/Bulletin/InternalResource/38151_MBA_Monograph_No1.pdf; Jody Shenn, *ARM Lenders Prep for Wave Of Teaser-Rate Expirations*, AM. BANKER, Jan. 18, 2006; Ruth Simon, *Home Rundown: A look at the pros and cons of different types of mortgages – and which one may be the best for you now*, WALL ST. J., Jan. 16, 2006, R4.

[78] *See* Allen J. Fishbein & Patrick Woodall, Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders 7 (Consumer Fed'n of America May 2006), available at www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf.

[79] Mortgage Bankers Ass'n, *supra* note 77, at 56.

interest payments for the remainder of the loan. Option ARMs present the same risks of payment shock as I-O ARMs, plus the risk that the principal may have grown over time due to negative amortization, further increasing the eventual payments. Even before the introductory period expires, payments can also go up if negative amortization boosts the balance on the loan above a specified level, generally 110 to 125 percent of the original loan amount.[80] For all of these reasons, Option ARMs "are the most likely" of all nontraditional mortgages "to default."[81]

Both types of loan have made inroads into the subprime market. By the third quarter of 2005, over one-quarter of new subprime loans were I-O loans.[82] Similarly, a recent study found that option ARM borrowers had "lower credit scores than borrowers overall" and often had subprime credit scores (usually defined as FICO scores below 660).[83] The same study found that African-American and Latino borrowers were more likely to receive I-O and option ARMs than non-minority borrowers after controlling for income, debt loads and credit scores.[84]

There are substantial reasons for concern about the payment shock associated with I-O and option ARMs, particularly for cash-strapped subprime borrowers. One industry commentator warned that when interest rates reset from teaser rates on both types of loans, monthly payments could double:[85]

> It is important to note that a household facing a doubling of mortgage payments will be in difficulty, whether that increase is applied in a single month or in a series of incremental steps spread over two years. . . . [A] loan with an initial [teaser] rate of 1 percent that resets to a market rate of 6.3 percent will experience a substantial increase in payments, all the more so if negative amortization has increased the total principal amount subject to interest. That type of loan will experience *reset payment sensitivity*. An option-payment loan with a minimum payment *below* that of a 1 percent loan will face even greater reset sensitivity.

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[80] When this happens, the loan "recasts." *See* Cagan, *supra* note 77, at 17; Simon, *supra* note 77, at R4.

[81] Cagan, *supra* note 77, at 29.

[82] Doug Duncan, MBA Nonprime Conference (PowerPoint presentation May 22, 2006), available at www.mbaa.org/files/Conferences/2006/Non-Prime/MarketOutlook.ppt#397,1,MBA Nonprime Conference (viewed July 17, 2006). In the first quarter of 2006, originations of I-O loans dropped 30% from the previous quarter, but still remained substantial. Standard & Poor's, Sector Report Card: The Heat Is On For Subprime Mortgages 3 (July 10, 2006).

[83] *See* Fishbein & Woodall, *supra* note 78, at 25-26.

[84] *See id.* at 22, 24.

[85] Cagan, *supra* note 77, at 19 (emphasis in original); *see also id.* at 21, 25 (for teaser rate loans, when "the loans finally adjust to fully amortizing market-rate levels, the payments will have increased by more than fifty percent from their initial amounts. Often the payments will have doubled, or more than doubled."); Simon, *supra* note 77, at R4 ("If rates go up by two percentage points, monthly payments could nearly double"). While Cagan discounted the presence of teaser rates and thus of severity of reset adjustments for subprime loans (Cagan, *supra,* at 21), Fitch reported in 2006 that the "current environment" was of "deeply teased short-term subprime hybrid ARMs combined with an interest-only affordability feature." FitchRatings, Rating Subprime RMBS Backed By Interest-Only ARMs 1 (March 9, 2006). *See also* Dep't of the Treasury et al., Interagency Guidance on Nontraditional Mortgage Products: Proposed guidance with request for comment, 70 Fed. Reg. 77249, 77253 (Dec. 29, 2005).

These dynamics can and do lead to increased subprime default rates. A recent Fannie Mae analysis of subprime ARMs that underwent rate reset and were originated between March 2003 and March 2004 found, for instance, that sixteen percent of the borrowers had defaulted or were late making payments by mid 2006.[86]

The prevalence of I-O and Option ARMs in the subprime market suggests that these loans are often underwritten for the wrong reason. Due to the potential for large payment shock, these products are best-suited for borrowers who have large disposable incomes, receive bonuses, or expect their income to rise sharply during the introductory period.[87] None of these conditions normally holds for subprime borrowers. Rather, subprime borrowers usually take out these loans to minimize their monthly payments on large loan balances. Sometimes they do so to buy a larger house or refinance large debts. Other times, they do so to buy a starter home, in regions where payments on a fixed-rate loan on a starter home would be beyond their means.[88] This is particularly common in overheated coastal real estate markets such as California.[89] Many lenders approve these loans to subprime borrowers based solely on a household's ability to pay the initial monthly payments, not the fully indexed rate.[90] As Fitch has warned, however, when lenders qualify financially strapped borrowers for loans only "at the initial rate and IO payments," not the larger eventual payments, the "payment shock is exacerbated."[91] When the loans reset and the payments go up, many of these borrowers will find that they can no longer afford the payments.[92] At that point, borrowers will either have to refinance (which likely will be difficult), sell their homes or go into default. Fitch predicts that as "home price stabilize and interest rates rise, . . . subprime IO delinquency rates [will] increase."[93]

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86 *See* Vikas Bajaj & Ron Nixon, *Variable Loans Help to Put Off Mortgage Pain*, N.Y. TIMES, July 23, 2006, A1, A20. Fitch Ratings estimates that thirty percent of all subprime loans will undergo rate reset in 2006 and another twenty-two percent in 2007, many of which are I-O or other ARMs. FitchRatings, *supra* note 85, at 13.

87 *See* Cagan, *supra* note 77, at 17 (commenting that "[t]hese loans . . . may be useful to homeowners who anticipate substantial increases in their income (such as recent graduates from law school) , and to those who have low incomes for most of the year but receive high lump sum payments from time to time (such as people who are self-employed or professionals who receive much of their income in the form of a yearly bonus"); Mortgage Bankers Ass'n, *supra* note 77, at 55-56; Simon, *supra* note 77, at R4.

88 *See* Cagan, *supra* note 77, at 14, 17 ("observing that "many adjustable-rate mortgage borrowers . . . bought recently and stretched their financial abilities to acquire a home with a low down payment and a low monthly payment"); Mortgage Bankers Ass'n, *supra* note 77, at 56, 58; Ruth Simon, *Option ARMs Remain Popular In Spite of Risks*, WALL ST. J., Aug. 15, 2005, A2 (stating that "borrowers seeking to lower their monthly payments have few other choices" than Option ARMs).

89 *See* Fishbein & Woodall, *supra* note 78, at 4; Mortgage Bankers Ass'n, *supra* note 77, at 50.

90 *See* Shenn, *supra* note 77 (reporting that "standards loosened throughout 2004 and 2005, particularly through the increased use of 'stated' incomes, higher debt-to-income ratios, and low down payments."). In 2006, federal banking regulators issued a proposed interagency guidance that would require federally insured depository institutions who makes I-O and Option ARM loans to "address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins." Dep't of the Treasury et al., Interagency Guidance on Nontraditional Mortgage Products: Proposed guidance with request for comment, 70 Fed. Reg. 77249, 77252 (Dec. 29, 2005). The regulators issued the proposed guidance out of concern that these products "are being offered to a wider spectrum of borrowers, including some who may not otherwise qualify for traditional fixed-rate or other adjustable-rate mortgage loans, and who may not fully understand the associated risks." *Id.* at 77250.

91 *See* FitchRatings, *supra* note 85, at 11.

92 *See id.* at 10-11.

93 *See id.* at 13. *See also* Dep't of the Treasury et al., Interagency Guidance on Nontraditional Mortgage Products: Proposed guidance with request for comment, 70 Fed. Reg. 77249, 77255 (Dec. 29, 2005); Ruth Simon,

Consequently, it is essential that all borrowers, including subprime borrowers, understand the worst case payment scenario before they take out I-O and option ARMs. Current TILA disclosures – based on an unrealistic, hypothetical $10,000 loan – are impossible for most consumers to comprehend. Even a sophisticated borrower would need to locate the hypotheticals in the sea of variable-rate disclosures and take the time to do the math. Thus, it comes as no surprise that residential borrowers with adjustable-rate mortgages "appear to underestimate the amount . . . their interest rates can change."[94] "Borrowers with less income or education seem especially likely not to know their mortgage terms," making them "more vulnerable to an increase in interest rates."[95]

V. What To Do?

For all of these reasons, federal mortgage disclosures break down in a world of risk-based pricing. TILA and RESPA do not mandate reliable information for meaningful comparison-shopping in the subprime market before application and the subprime market does not provide it. In fact, TILA unwittingly countenances affirmative misrepresentations to subprime customers by permitting lenders to tout their best rates and nothing else. Similarly, in most cases, nothing in TILA or RESPA requires lenders to provide firm price disclosures until the date of closing. These problems are compounded in the case of variable-rate loans because current variable-rate disclosures camouflage the information that is most important to subprime borrowers, *i.e.*, the worst payment case scenario. While revamped disclosures are not a panacea for the price revelation problems in the subprime market, they are an important part of the solution, as I now describe.

A. Counteracting False Subprime Advertising

Currently, virtually all subprime ads that publicize rates only quote the best rates (and, for variable-rate loans, often these are teaser rates).[96] For everyone except customers who actually qualify for the advertised rates, these ads are patently misleading. If comparison-shopping is to be meaningful, it is critical to eliminate false advertising that is designed to lure naive consumers down the primrose path to higher, hidden prices. Concomitantly, improved oversight could help make subprime advertising a vehicle for accurate price revelation.

Achieving truth in subprime advertising requires at least four distinct measures. First, any lender who advertises an APR for a subprime product should be required to advertise the full range of APRs that it charges for that product. Immediately next to this price range a warning needs to appear that customers with weak credit will not qualify for the best price. Second, both

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Option ARMs Remain Popular In Spite of Risks, *supra* note 88, at A2 (describing 2006 Credit Suisse Group report stating that "[o]ption ARMs are going into foreclosure an average of 10 months after the loan is made, earlier than for other types of loans").

[94] Brian Bucks & Karen Pence, Do Homeowners Know Their House Value and Mortgage Terms? 2 (Fed. Res. Bd. Working paper Jan. 2006), available at www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf. *See also* note 43.

[95] Bucks & Pence, *supra* note 94, at 26.

[96] Assuming, that is, that the advertisement is truthful. Some subprime advertisements list rates that the lender does not in fact offer.

of these disclosures need to be prominent, in boldface, and with a large font.[97] Third, for ads marketing adjustable-rate mortgages, the text should prominently state the maximum APR cap for the highest-priced version of the loan to give consumers some warning of the worst case payment scenario. Finally, Congress should amend TILA and RESPA to provide a private right of action to borrowers who enter into abusive loans in reliance on misleading subprime advertisements.

Of these measures, only the last one expanding private rights of action for false advertising under TILA and RESPA would require Congressional authorization. The other three measures fall well within the regulatory authority of the Federal Reserve Board to interpret TILA.

B. Providing Firm Price Quotes To Subprime Customers Before Application

In an ideal world, subprime customers could get firm quotes for free without paying for a mortgage application and could then shop the quotes with other lenders. The wrinkle, of course, is that subprime customers have to reveal their creditworthiness before lenders can compute a price. Today, that is accomplished through the loan application process, complete with a substantial nonrefundable application fee. However, given the prevalence of rate sheets, automated credit scores, and automated underwriting, there is no reason why subprime customers should have to make costly formal applications in order to obtain firm price quotes.

The costs of subprime mortgages fall into two broad categories: price terms and closing costs.[98] Price terms include interest, points, origination fees, broker fees, yield spread premiums, and prepayment penalties. Under risk-based pricing, these terms can be computed by consulting a lender's rate sheet and determining where a customer falls on that rate sheet, depending on his or her credit scores and loan-to-value ratio. Alternatively, lenders who determine prices using more sophisticated automated underwriting systems could interview the customer for the key underwriting variables, enter those variables in the system, and obtain a price quote in seconds.[99] With the customer's permission, a lender can obtain the customer's credit report and credit

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[97] In December 2003, the Federal Reserve Board proposed rules to standardize the meaning of the "clear and conspicuous" standard. *See* Federal Reserve Board, Truth in Lending, Proposed Rule, 68 Fed. Reg. 68793 (Dec. 10, 2003). In June 2004, the Board withdrew the proposed rule under intense fire from lenders. Federal Reserve Board, Equal Credit Opportunity, Electronic Fund Transfers, Consumer Leasing, Truth in Lending, Truth in Savings, 69 Fed. Reg. 35541 (June 25, 2004). The following year, in the bankruptcy reform law, Congress required the Board in consultation with other federal banking regulators and the Federal Trade Commission to promulgate new regulations on the meaning of "clear and conspicuous" standard for open-end credit plans such as credit cards designed to result "in disclosures which are reasonably understandable and designed to call attention to the nature and significance of the information in the notice." Pub. L. No. 109-8, 119 Stat. 23, Title XIII, § 1309 (2005). The Board proposed the mandated rule in October 2005. Federal Reserve Board, Truth in Lending, 70 Fed. Reg. 60235 (Oct. 17, 2005).

[98] *See* HUD-Fed Joint Report, *supra* note 13, at 40-41.

[99] For descriptions of automated underwriting for applicants with weak credit, see Susan Wharton Gates, Vanessa Gail Perry, & Peter M. Zorn, *Automated Underwriting in Mortgage Lending: Good News for the Underserved?*, 13 HOUSING POLICY DEBATE 369 (2002); Susan Wharton Gates, Cindy Waldron, & Peter Zorn, Automated Underwriting: Friend or Foe to Low-Mod Households and Neighborhoods? (Freddie Mac working paper, November 2003); and John W. Straka, *A Shift in the Mortgage Landscape: The 1990s Move to Automated Credit Evaluations*, 11 J. HOUSING RESEARCH 207 (2000).

scores online for no more than $10 to $15. Similarly, the loan-to-value ratio can be estimated using the proposed down payment and the purchase price of the home.

Consequently, it is now technologically feasible for lenders and brokers to provide firm price quotes at a nominal fee upfront to subprime customers. Indeed, the Department of Housing and Urban Development reached that conclusion in 1998, when it proposed requiring lenders and brokers to provide firm price quotes before application in order to gain immunity from RESPA's anti-kickback provisions.[100] Eight more years have elapsed and automated underwriting systems have become prevalent in the subprime industry.[101] Accordingly, lenders and brokers have the technical capability to provide legally binding, written price quotes to subprime customers, if not for free, then for the cost of pulling the credit report. Lenders should be required to provide such quotes for all loans using risk-based pricing, according to a fee schedule regulated by law, in advance of payment of other nonrefundable fees.

Critics have argued that lenders cannot provide firm price quotes before verifying customer representations or entering into lock-in commitments.[102] While these are legitimate concerns, neither poses an insuperable bar. Price quotes are always contingent on verification in the prime market and the same would be true in subprime.[103] In the subprime context, moreover, the only information that requires verification on numerous rate sheets is the loan-to-value ratio

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[100] *See* HUD-Fed Joint Report, *supra* note 13, at 28-29, 39-42; Department of Housing & Urban Development, Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgages To Reduce Settlement Costs to Consumers, 67 Fed. Reg. 49134 (July 29, 2002) [hereinafter cited as HUD Guaranteed Package Rule].

The anti-kickback provisions of Section 8 of RESPA prohibit referral fees, fee splitting, and unearned fees in residential mortgage transactions. 12 U.S.C. § 2607. When HUD originally proposed guaranteed closing cost packages, it recommended immunizing yield spread premiums from Section 8 as an inducement to the lending industry to embrace the proposal. *See* HUD-Fed Joint Report, *supra* note 13, at 22, 29-30; HUD Guaranteed Package Rule, *supra,* at 49160-61. The inducement did not work and, more importantly, is economically perverse. Yield spread premiums are *per se* anticompetitive and hurt consumer welfare because they constitute a reward by lenders to mortgage brokers for pushing up the interest rate above what the lender would otherwise accept. *See, e.g.*, Departments of the Treasury & Housing and Urban Development, *Curbing Predatory Home Mortgage Lending* 40 (June 20, 2000); Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premia" Before the Senate Comm. on Banking, Housing, and Urban Affairs, 107th Cong., 2d Sess. 3 (2002) (testimony of Prof. Howell E. Jackson) (concluding that yield spread premia "serve only to [benefit] mortgage brokers," not consumers, and levy "implicit interest rates [that] are absolutely outrageous"), *available at* banking.senate.gov/02_01hrg/010802/jackson.htm; Howell E. Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premia (Jan. 8, 2002), *available at* www.law.harvard.edu/faculty/hjackson/jacksonberry0108.pdf.

Provisions in TILA and RESPA that allow lenders to change most loan terms until the last minute facilitate this practice by allowing lenders and brokers to negotiate yield spread premiums in exchange for higher rates behind the scenes and then spring costlier loans on borrowers at closing. Accordingly, any proposal for a guaranteed closing cost package should ban the use of yield spread premiums in exchange for higher interest rates, points, or fees or prepayment penalties.

[101] According to FitchRatings, automated "compliance systems have become a critical component of the underwriting and quality control process" in the subprime residential mortgage industry. FitchRatings, Fitch Revises RMBS Guidelines for Antipredatory Lending Laws (Feb. 23, 2005).

[102] *See* HUD-Fed Joint Report, *supra* note 13, at 40-41.

[103] *See* HUD-Fed Joint Report, *supra* note 13, at 42.

(calculated from the down payment and the property value), because the credit history and score are available from a trusted third party online. In any event, the surge of low-documentation and no-documentation loans in the subprime market belies a strict need for many types of verification. And as for the issue of lock-in commitments, HUD proposed a satisfactory resolution of that issue in 1998:[104]

> The [price term] guarantee would stand for a reasonable time to permit the consumer to shop. And unless the borrower chose for formally apply and "lock" the interest rate, any subsequent change in interest rate and points (but not closing costs) would be permitted, so long as any change to the consumer's guaranteed rate was solely attributable to, and commensurate with, changes in the financial markets.

HUD's language similarly underscores the need for increased lock-in commitments in the subprime market.

With respect to closing costs, the time has come to require legally binding quotes on guaranteed closing cost packages in advance of a nonrefundable application fee.[105] This reform is long overdue in the prime market, but it has special urgency in the subprime market, where closing costs are substantially higher on average, relative to the amount financed, than in the prime market. Guaranteed packages would include numerous settlement costs associated with subprime mortgages, including fees for services provided by creditors and third-party vendors, plus official filing and recording fees. Examples of these costs include broker compensation and fees for appraisals, surveys, credit reports, underwriting, recording, legal representation, title insurance and title searches.[106] Guaranteed packages would need to go hand-in-hand with firm price quotes to prevent lenders from undermining the closing cost quotes by increasing the price terms after the fact.[107] Lenders would continue to have to provide borrowers with HUD-1s at closing to permit borrowers to verify that the guarantee was honored. Providing customers with guaranteed closing cost packages before application would enable them to do intelligent comparison-shopping about closing costs.

The Federal Reserve Board and HUD have full authority to accomplish firm price quotes through notice-and-comment rulemakings. The Truth-in-Lending Act requires disclosures "before the credit is extended,"[108] which gives the Board ample latitude to require firm price term disclosures early in the shopping process. Similarly, HUD felt confident enough about its

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[104] HUD-Fed Joint Report, *supra* note 13, at 42. In addition to interest rate and points, origination fees and prepayment penalties would also be covered as price terms.

[105] The Department of Housing and Urban Development and the Federal Reserve Board advanced a similar proposal in 1998. *See* HUD-Fed Joint Report, *supra* note 13, at 32-33. HUD formally proposed a guaranteed closing cost rule in 2002 but eventually allowed the proposal to languish due to industry and consumer group opposition. *See* HUD Guaranteed Package Rule, *supra* note 100.

[106] *See* HUD-Fed Joint Report, *supra* note 13, at 23-25. The cost of homeowners' insurance and transfer taxes would be excluded from guaranteed closing cost packages because these items depend on consumer choices unrelated to the credit transaction. *See id.* at 24. For discussion of other operational issues in implementing guaranteed closing cost packages, see *id.* at 25-31.

[107] *See id.* at 22, 28-29.

[108] 15 U.S.C. § 1638(b)(1).

authority to mandate a guaranteed closing cost package under RESPA that it proposed a rule to that effect in 2002.[109] Thus, firm price quotes could be attained without the need for Congressional authorization.

C. Addressing The Moving Target Problem

Requiring firm price quotes and guaranteed closing cost packages would go a long way toward addressing the moving target problem in subprime. It would not entirely eliminate it, however. The price quotes just proposed would be subject to verification and could be raised if the customer's creditworthiness turned out to be worse than originally portrayed. Similarly, lenders would have latitude to increase price terms to account for interest rate movements, absent lock-in commitments. Accordingly, the need for verification and financial market movements create openings for the moving target problem and the potential for surprise price hikes at closing.

While the moving target problem cannot be wholly eliminated, it can be substantially constrained. First, the reasons for any price hike should be strictly regulated. Lenders should only be allowed to alter price quotes for three reasons: (1) good faith subsequent discoveries or events resulting in a downgrade of a customer's creditworthiness; (2) lower-than-expected appraisals affecting loan-to-value ratios; and (3) prevailing interest rate movements after application (barring any lock-in commitment), and only on the condition that any price changes be commensurate. With respect to (1), lenders would be barred from raising prices with respect to information (such as prior delinquencies or bankruptcies) that was already available from the customer's online credit report on the date of the price quote. Furthermore, no price changes would be allowed resulting from behind-the-scenes compensation negotiations for mortgage brokers, loan officers, or other lending personnel.

Second, when legitimate reasons did exist for price changes, only the nominal interest rate, discount points, or origination fees could be changed. The lender could not unilaterally change closing costs, including broker compensation, guaranteed in the closing cost package. Limiting price increases to the nominal interest rate, discount points, or origination fees would help promote transparency in pricing.

Lastly, lenders who change price quotes to borrowers' detriment should be required to deliver written disclosures announcing any new nominal interest rate, points, origination fees, finance charge, and APR, to borrowers no later than seven days before the closing.[110] In cases where the lender also changes the loan product (such as from a fixed-rate loan to an adjustable-rate loan), the new variable rate disclosures discussed in the next section, where applicable, would be required. Delivery of such disclosures would be automatic and would not require a prior request by the borrower. The accuracy of all new disclosures and price terms would be

[109] *See* HUD Guaranteed Package Rule, *supra* note 100.

[110] Tolerances could be used to excuse lenders from redisclosure for minor changes in the APR. Tolerances of 1/8 of one basis point for regular transactions and ¼ of one basis point for irregular transactions would be appropriate. *See* note 47 *supra* and accompanying text.

legally binding on the lender and would entitle the borrower to damages if breached.[111] In addition, any unilateral change in terms at closing by the lender should entitle the borrower to a three-year right of rescission.[112]

All of these changes except the expanded right of rescission under TILA could all be jointly accomplished by HUD under RESPA and the Federal Reserve Board under TILA without additional Congressional authority. Indeed, HUD embraced many of these changes in its proposed guaranteed closing cost package rule in 2002.[113]

D. Fixing Variable-Rate Disclosures

Currently, variable-rate disclosures under TILA must recite most of the individual moving parts that drive the worst case payment scenario, such as the index, the margin, reset dates, individual reset caps, and lifetime maximum and minimum interest caps. These drivers of the worst case payment scenario are also found in the loan note at closing. What most consumers care about, however, is not the moving parts, but how high their principal and interest payments could go if the loan becomes fully indexed (and becomes fully amortizing, in the case of I-O and option ARM loans). Moreover, consumers want the actual worst case dollar figures for *their own* loans, not extrapolations from a $10,000 hypothetical. Today, automated programs make tailored disclosures such as these cheap and easy for lenders to provide.

Accordingly, variable-rate disclosures should be pared down and revised to contain just four things. First, these disclosures should make it unmistakably clear that the borrower has an adjustable-rate loan. Second, the disclosures should state the number of months or years until the first reset date and the maximum interest rate and monthly principal and interest payment on that date for the actual loan in question. Third, the disclosures should state the earliest date on which the loan could become fully indexed and the maximum interest rate and monthly payment on that date. Finally, the disclosures should state whether the loan will contain a prepayment penalty, and if so, the maximum dollar value of that penalty and how long it would last. The disclosures would look something like the sample proposed disclosure in Exhibit 4.

Lenders would have to provide these disclosures in writing along with the initial firm quotes (or, for prime loans, before provision of an application form or payment of a nonrefundable fee, whichever is earlier). In cases where the lender later changed the price terms or loan product for permissible reasons, it would need to make new, written variable-rate disclosures (where applicable) no later than seven days before closing.

No Congressional authorization would be needed to make this change. The Federal Reserve Board has full authority under TILA to implement these changes.

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111 *See* HUD-Fed Joint Report, *supra* note 13, at 44.
112 *See* note 25 *supra.*
113 *See* HUD Guaranteed Package Rule, *supra* note 100.

Conclusion

Right now, the prime market and subprime markets are segmented. The prime market uses average-cost pricing and the subprime market uses risk-based pricing. But there is every reason to think that risk-based pricing will eventually pervade the prime market too and lead to the demise of average-cost pricing. The residential mortgage market has already started down this road with the invention of the A- customer (with slightly weaker credit than in prime) and the Alt-A customer (who looks strong on paper, but has little or no documentary support of income or employment). Eventually it is likely that we will have other shades of A borrowers, each of whom receives a somewhat variegated price.

Current federal mortgage disclosures had broken down in the face of risk-based pricing. My testimony advances proposals to repair federal mortgage disclosures and, in the process, to make possible meaningful comparison-shopping for mortgages.

Exhibits to McCoy Testimony, August 15, 2006

Exhibit 1: Subprime Rate Sheet

Table 2. IndyMac Bank: Subprime Wholesale Interest Rates

Effective:	4/17/03 7:19 AM	B2B Lending	www.indymacb2b.com
Rate Lock:	www.indymacb2b.com	Traditional Rate Lock Desk:	1-800-669-4300
e-MITS Help Desk:	1-888-56e-MITS		

Lender Insured, NO Reserve Requirements, and 6 x 30 Rolling Lates Counted as 1x30!
80/20 Now allows up to 1x30 day lates on mortgage rating—Level 1+ only
80/15 Now allows up to 2x30 day lates on mortgage rating—Level 1 and 1+ only
12 months bank statements as full doc if LTV is less than 80%—Self employed only

Full Doc				2/6 LIBOR Rates based on 2-YR PP–30 BE					3/1 Treasury Rates based on 3-YR PP–30 BE					2/6 & 3/1	30-Yr Fixed Rates based on 3-YR PP–30 BE				
Levels	FICO	LTV	DR	99	100	101	102	103	99	100	101	102	103	Margins	99	100	101	102	103
		65	55	5.875	6.375	6.875	7.500	8.375	6.125	6.625	7.125	7.750	8.625	4.500	6.875	7.250	7.750	8.375	9.000
		70	55	6.125	6.625	7.125	7.750	8.625	6.375	6.875	7.375	8.000	8.875	4.500	7.125	7.500	8.000	8.625	9.250
		75	55	6.250	6.750	7.250	7.875	8.750	6.500	7.000	7.500	8.125	9.000	4.500	7.250	7.625	8.125	8.750	9.375
Level	600-	80	55	6.375	6.875	7.375	8.000	8.875	6.625	7.125	7.625	8.250	9.125	4.500	7.375	7.750	8.250	8.875	9.500
1+	up	85	50	6.750	7.250	7.750	8.375	9.250	7.000	7.500	8.000	8.625	9.500	4.500	7.750	8.125	8.625	9.250	9.875
		90	50	7.000	7.500	8.000	8.625	9.500	7.250	7.750	8.250	8.875	9.750	4.500	8.000	8.375	8.875	9.500	10.125
		95	45	7.250	7.750	8.250	8.875	9.750	7.500	8.000	8.500	9.125	10.000	4.500	8.250	8.625	9.125	9.750	10.375
		65	55	6.250	6.750	7.250	7.875	8.750	6.500	7.000	7.500	8.125	9.000	5.000	7.500	7.875	8.375	9.000	9.625
		70	55	6.500	7.000	7.500	8.125	9.000	6.750	7.250	7.750	8.375	9.250	5.000	7.750	8.125	8.625	9.250	9.875
Level	575-	75	55	6.625	7.125	7.625	8.250	9.125	6.875	7.375	7.875	8.500	9.375	5.000	7.875	8.250	8.750	9.375	10.000
I	599	80	55	6.750	7.250	7.750	8.375	9.250	7.000	7.500	8.000	8.625	9.500	5.000	8.000	8.375	8.875	9.500	10.125
		85	50	7.125	7.625	8.125	8.750	9.625	7.375	7.875	8.375	9.000	9.875	5.000	8.375	8.750	9.250	9.875	10.500
		90	50	7.375	7.875	8.375	9.000	9.875	7.625	8.125	8.625	9.250	10.125	5.000	8.625	9.000	9.500	10.125	10.750
		65	55	6.750	7.250	7.750	8.375	9.250	7.000	7.500	8.000	8.625	9.500	5.250	7.875	8.250	8.750	9.375	10.000
		70	55	7.000	7.500	8.000	8.625	9.500	7.250	7.750	8.250	8.875	9.750	5.250	8.125	8.500	9.000	9.625	10.250
Level	550-	75	55	7.125	7.625	8.125	8.750	9.625	7.375	7.875	8.375	9.000	9.875	5.250	8.250	8.625	9.125	9.750	10.375
II	574	80	55	7.250	7.750	8.250	8.875	9.750	7.500	8.000	8.500	9.125	10.000	5.250	8.375	8.750	9.250	9.875	10.500
		85	50	7.625	8.125	8.625	9.250	10.125	7.875	8.375	8.875	9.500	10.375	5.250	8.750	9.125	9.625	10.250	10.875
Level	525-	65	55	8.500	9.000	9.500	10.125	11.000	8.750	9.250	9.750	10.375	N/A	6.000	9.875	10.25	10.750	11.375	N/A
III	549	70	55	8.750	9.250	9.750	10.375	11.250	9.000	9.500	10.000	10.625	N/A	6.000	10.125	10.50	11.000	N/A	N/A
		75	55	8.875	9.375	9.875	10.500	11.375	9.125	9.625	10.125	10.750	N/A	6.000	10.25	10.625	11.125	N/A	N/A
Level	500-	65	55	10.000	10.500	11.000	11.625	N/A	10.250	10.750	11.250	11.875	N/A	7.000	11.125	11.500	12.000	N/A	N/A
IV	524																		

Table 2. IndyMac Bank: Subprime Wholesale Interest Rates *continued*

Stated Income				2/6 LIBOR Rates based on 2-YR PP—30 BE					3/1 Treasury Rates based on 3-YR PP—30 BE					2/6 & 3/1	30-Yr Fixed Rates based on 3-YR PP—30 BE				
Levels	FICO	LTV	DR	99	100	101	102	103	99	100	101	102	103	Margins	99	100	101	102	103
Level I+	600-up	65	55	6.250	6.750	7.250	7.875	8.750	6.500	7.000	7.500	8.125	9.000	4.875	7.250	7.625	8.125	8.750	9.375
		70	55	6.500	7.000	7.500	8.125	9.000	6.750	7.250	7.750	8.375	9.250	4.875	7.500	7.875	8.375	9.000	9.625
		75	55	6.625	7.125	7.625	8.250	9.125	6.875	7.375	7.875	8.500	9.375	4.875	7.625	8.000	8.500	9.125	9.750
		80	55	6.750	7.250	7.750	8.375	9.250	7.000	7.500	8.000	8.625	9.500	4.875	7.750	8.125	8.625	9.250	9.875
		85	50	7.125	7.625	8.125	8.750	9.625	7.375	7.875	8.375	9.000	9.875	4.875	8.125	8.500	9.000	9.625	10.250
Level 1	575-599	65	55	6.625	7.125	7.625	8.250	9.125	6.875	7.375	7.875	8.500	9.375	5.375	7.875	8.250	8.750	9.375	10.000
		70	55	6.875	7.375	7.875	8.500	9.375	7.125	7.625	8.125	8.750	9.625	5.375	8.125	8.500	9.000	9.625	10.250
		75	55	7.000	7.500	8.000	8.625	9.500	7.250	7.750	8.250	8.875	9.750	5.375	8.250	8.625	9.125	9.750	10.375
		80	55	7.125	7.625	8.125	8.750	9.625	7.375	7.875	8.375	9.000	9.875	5.375	8.375	8.750	9.250	9.875	10.500
Level II	550-574	65	55	7.125	7.625	8.125	8.750	9.625	7.375	7.875	8.375	9.000	9.875	5.625	8.250	8.625	9.125	9.750	10.375
		70	55	7.375	7.875	8.375	9.000	9.875	7.625	8.125	8.625	9.250	10.125	5.625	8.500	8.875	9.375	10.000	10.625
		75	55	7.500	8.000	8.500	9.125	10.000	7.750	8.250	8.750	9.375	10.250	5.625	8.625	9.000	9.500	10.125	10.750
Level III	525-549	65	55	8.875	9.375	9.875	10.500	11.375	9.125	9.625	10.125	10.750	N/A	6.375	10.250	10.625	11.125	11.750	N/A

Rate & Margin Adjustments	Rate	Margin
Limited Doc—Based on Full Doc	0.250	0.250
No Ratio—Based on Stated Income	0.375	0.375
2nd Home	0.500	0.500
Non Owner Occupied	0.750	0.750
2–4 Units	0.250	0.250
Low-rise Condo	0.250	0.250
Loan Amount ≥ $150k to $500k	(0.250)	(0.250)
Adj from F30, F30/15, or F15	(0.125)	(0.125)

Prepay Penalty Rate Adjustments	2-YR Fixed	30 Fixed/3:1 ARM
0 Years Prepay Penalty	0.500	0.750
1 Years Prepay Penalty	0.375	0.625
2 Years Prepay Penalty	0.000	0.500
3 Years Prepay Penalty	(0.500)	0.000
Credit Score Rate Adjustments		
Credit Score 620-640	(0.125)	
Credit Score 641-660	(0.250)	
Credit Score 661-up	(0.500)	
Borrower Paid MI Rate Adjustments		
LTV 80.01—85%	(0.375)	
LTV 85.01—90%	(0.625)	
LTV 90.01—95%	(0.875)	
Max Price/Yield Spread		
Max Price with 0-YR PPP	101.0	
Max Price with 1-YR PPP	101.5	
Max Price with 2-YR PPP	102.0	
Max Price with 3-YR PPP	103.0	

Rates, comparisons, fees and programs are subject to change without notice. Information is intended for Mortgage Professionals only, and not for distribution to consumers, as defined by Section 226.2 of Reg. Z, which implements the Truth in Lending Act. IndyMac Bank does not represent or warrant the accuracy of the competitors' data. Ratesheets do not represent guidelines. Refer to IndyMac

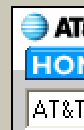

Exhibit 2: Subprime rate sheets are treated as proprietary secrets

See * footnote at bottom of next page

ARM
12 MAT, LIB & Treasury A
learn more...

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Bond Market		
5 yr Bond	4.58%	-0.110
10 yr Bond	4.64%	-0.089
30 yr Bond	4.68%	-0.069
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Equity Market		
DJIA	11,277.83	+68.06
NASDAQ	2,320.71	+8.87
S&P500	1,310.02	+7.00
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Spanish Web Site
Get marketing materials and product info in Spanish.
more info

Exhibit 3: Subprime lenders advertise best rates with negligible disclaimers:

Search conducted on July 4, 2006 for quotes on a 30-year fixed mortgage originated in Atlanta, based on relatively low FICO score of 590

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Low	6.29%
High	7.83%
Average	6.96%

Click term for definition ▶	Rate (%)	Points (%)	APR* (%)	Percent Down (%)	FICO® Range	Details
Sort by (click circle) ▶						
Dana Capital Group	6.10	1.50	6.29	10.00	540-619	More Info
Hometown Lenders	6.38	1.31	6.56	20.00	551-619	More Info
Hometown Lenders	6.38	1.31	6.56	5.00	580-619	More Info
Dana Capital Group	6.38	1.00	6.53	10.00	540-619	More Info
DiTech	6.50	2.00	7.33	20.00	350-850	More Info

If one clicks on “Details” for “More Info,” eventually one finds the following disclosure:

‘*Annual percentage rate is shown as "APR" in the table. The rates above were collected by Bankrate.com on the dates specified. Rates are subject to change without notice and may vary from branch to branch. ***Rate/APR and terms may vary based on the creditworthiness of the individual and the extent to which the loan differs from the one used for Bankrate.com quotes***.’

Exhibit 4: Sample Variable-Rate Disclosure

You have asked for information about a variable-rate loan. With this loan, your interest rate and monthly payments would probably increase over time.

- In ***two years*** from the closing, your principal and interest payments could rise as high as $1,950 per month and your interest rate could rise as high as 9.00% per year.
- In ***six years*** from the closing, your principal and interest payments could rise as high as $2,572 per month and your interest rate could rise as high as 14.00% per year. This is the highest your principal and interest payments and your interest rate could go under this loan.

Warning: If you pay off most or all of your loan within two years of the closing, you will have to pay your lender a penalty of as much as $9,000.