National Consumer Law Center
Meeting at Office of the Federal Reserve Board on January 31, 2008
Regulation Z (Truth in Lending)
Docket Number R-1286

On January 31, 2008, consumer advocates and representatives of the National Consumer Law Center (NCLC) met with Chairman Bernanke, Governor Kroszner, and members of the Board's staff to provide comments on the recently proposed amendments to Regulation Z to protect consumers in the mortgage market from unfair, abusive, or deceptive practices. Attending the meeting for NCLC was Ms. Jessica Attie, Ms. Karen Brown, Ms. Alys Cohen, Ms. Elizabeth Renuart, and Ms. Diane Thompson. Also in attendance were staff of the Division of Consumer and Community Affairs, including the Director, Sandra Braunstein, Associate Director Leonard Chain, and Assistant Director James Michaels. Stephanie Martin, Associate General Counsel, also attended.

The consumer advocates and NCLC representatives made the following points during the meeting:

1. They addressed the scope of the proposal and the Board's determination to apply certain rules to higher priced loans. They noted that where state laws have been enacted to address harmful lending practices for high priced loan, harmful practices also occur below the price triggers. They urged the Board to create a "level playing field" by adopting the same protections for all home-secured credit, including home-equity lines of credit.

2. The consumer advocates also addressed the Board's proposal to prohibit lenders from engaging in a pattern or practice of making higher priced loans without regard to consumers' repayment ability. They stated that the burden on consumers to establish a "pattern or practice" of making unaffordable loans would be too great. They asserted that the Board should adopt bright-line rules with specific standards for a debt-to-income ratio and residual income, which would create a presumption about the loan's affordability.

3. When verifying consumers' income, they supported the proposal to allow creditors to rely on third-party documents, but suggested that the rule require creditors to use the best and most reliable documents available. They were concerned about enforcement of the rule and oppose the creation of a safe harbor for creditors that fail to verify income.

4. The consumer advocates supported the Board's proposal to require, for all home-secured loans, that creditors provide a good faith estimate of the loan costs within three days after the consumer applies for the loan. They asserted that if the loan terms change, the creditor should be required to provide new disclosures reflecting the changed terms a certain number of days before the loan is consummated.

5. They suggested that the Board should provide guidance to courts, by issuing rules that set standards for the award of actual damages for violations of Regulation Z. They also

noted that the Truth in Lending Act imposes civil liability only for creditors that violate the act or regulation, and in some cases assignees holding the loan. Accordingly, with regard to the proposed rules governing mortgage servicing activities, the consumer advocates are concerned that neither the creditor nor the loan servicer may be subject to civil liability for violations. They suggested revising the rules to make creditors liable for the actions of the loan servicer.

6. They also advocated that the Board issue a rule to make assignees liable for violations that would be apparent from a review of the entire loan file. Currently, assignees are only liable for violations that are apparent on the face of certain loan documents.

7. Consumer advocates suggested that the Board propose a rule allowing consumers to exercise the rescission remedy in section 125 of the Truth in Lending Act if the creditor failed to provide good faith estimates of the loan costs within three days after the consumer applies for the loan.

A copy of the written materials provided by NCLC in connection with the meeting are attached to this memorandum.

HELOC Loan Pool Data – selected pools

Loan Pool	Dollar volume	No. of HELOCs	% that are 2^{nd} or junior liens	% that are cash out/refi	% that are stated income	Performance data – delinquencies
IndyMac Home Equity Mortgage Loan Asset-Backed Trust, Series 2007-H1	$650 million	8,659 (80% originated by IndyMac Bank)	98%	80%	78%	as of August 2007: 6.18% of the 2005 HELOCs, 5.89% of the 2006 HELOCs, and 3.97% of the 2007 HELOCs.
IndyMac Home Equity Mortgage Loan Asset-Backed Trust, Series 2006-H1	$490 million	8,012 (82% originated by IndyMac Bank)	98%	63%	95%	as of August 2007, 5.23% of the 2005 HELOCs, and 10.3% of the 2006 HELOCs
CWHEQ Revolving Home Equity Loan Trust, Series 2007-E	$900 million	13,213 (59% originated by Countrywide Bank, FSB and 41% by Countrywide Home Loans, Inc.)	98%			No performance data found
CWHEQ Revolving Home Equity Loan Trust, Series 2006-E	$1.5 billion	13,325	100%			No performance data found
SACO I Mortgage-Backed Notes Trust, 2006-8	$356 million	5,282 (31% originated by American Home Mortgage, 20% by SouthStar)	99%	32%	48%	As of March 2006, 3.84%
CitiGroup HELOC Trust 2006-NCB1	$794 million	18,041 (originated by National City Bank)	95%	14% refis, 66% stand alones	28% stated income; 100% interest only	No performance data found, but Moody's issued possible downgrade watch for several tranches.
First Horizon HELOC Notes 2006-HE1	$300 million	6,043	97%	76%	35%	As of Sept 2007, 5.62%. Moody's issued possible downgrade watch.
MSCC HELOC Trust 2007-1	$846 million, of which $730 million are HELOCs	8,632, of which 7,439 are HELOCs	76% of loans in pool are 2^{nd} liens; 80% of HELOCs in pool are 2^{nd} liens			Moody's issued possible downgrade watch for a tranche.
TOTAL	**$5.72 billion**	**80,014**				

In the 3^{rd} quarter of 2005, S&P rated 10 HELOC transactions totaling $13.553 billion. See "Trends in U.S. Residential Mortgage Products: Closed-End Seconds and HELOCs Sector, Third-Quarter 2005," Standard & Poor's, Jan. 18, 2006.

A Sampling of Data on ARM Foreclosure Rates Prior to the Reset

Borrowers with ARMs suffer a high rate of foreclosure prior to reset. Accordingly, default and foreclosure in many instances may be independent of payment shock. Policy solutions to the mortgage crisis must consider borrowers who obtained loans they never could afford.

- Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category 25, 32 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (average purchase money ARM that entered foreclosure did so only 12.4 months after origination)

- Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages* 15-17 (Federal Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006) (hybrid 2/28 ARMs have a higher probability of default at any age and the rate of default increases during the first two years, even before any payment shock)

- Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12 (Apr. 5, 2007), *available at* http://www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf (increase in early payment defaults within four months of origination)

- Lynne Dearborn, Mortgage Foreclosures and Predatory Practices in St. Clair County, Illinois, 1996-2000, at 23 (July 2003) (from 1996 to 2000, the proportion of foreclosure judgments attributable to ARMs increased from 11% to 30%; at the same time, the median age of the loan entering foreclosure declined from 4.1 years to 2.06 years, with default occurring three months typically before the initiation of foreclosure)

- Data on Atlanta foreclosures show that a majority of the foreclosures for the last two years have been ARMs, most of which are less than two years old.

Atlanta Foreclosures and ARMs	2006 Foreclosures	2007 Foreclosures
ARMs as % of foreclosure pool	54.56%	58.30%
ARMs less than 2 years old as % of foreclosure pool	45.63%	33.84%
ARMS less than 2 years old as % of all foreclosing ARMs	83.64%	58.05%

Source: Atlanta Foreclosure Report, Oct. 15, 2007 & May 16, 2006

Key Research on Utility of Disclosures

Consumers rely on TILA disclosures in shopping.

- Jinkook Lee & Jeanne M. Hogarth, *The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates*, 18 J. PUB. POL'Y & MARKETING 66, 74 (1999)
- Jinkook Lee & Jean M. Hogarth, *Consumer Information Search for Home Mortgages: Who, What, How Much and What Else?*, 9 FIN. SERVICES REV. 277, 286 (2000)

Standardized & simplified disclosures key for consumer shopping.

- MACRO INTERNATIONAL, INC., DESIGN AND TESTING OF EFFECTIVE TRUTH IN LENDING DISCLOSURES 9, 26 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf
- JAMES M. LACKO & JANIS K. PAPPALARDO, FED'L TRADE COMM'N, IMPROVING CONSUMER MORTGAGE DISCLOSURE: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS (2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf
- JAMES M. LACKO & JANIS K. PAPPALARDO, FED'L TRADE COMM'N, THE EFFECT OF MORTGAGE BROKER COMPENSATION DISCLOSURES ON CONSUMERS AND COMPETITION: A CONTROLLED EXPERIMENT (2004), *available at* http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf

Accurate TILA disclosures reduce the cost of credit.

- Victor Stango & Jonathan Zinman, How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets 3-4 (Sept. 5, 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928956

Consumers may ignore critical information at closing, given the volume of closing documents and the often rushed closings.

- Jacob Jacoby, *Perspectives on Information Overload*, 10 J. CONSUMER RES. 432, 435 (1984)
- Sprague v. Household Intern., 473 F. Supp.2d 966 (W.D.Mo. 2005) (closings of real estate loans of less than ten minutes at fast food restaurants and delis)

Financial services are marketed based on deep seated cognitive biases.

- Max H. Bazerman, *Consumer Research for Consumers,* 27 J. CONSUMER RES. 499, 502 (2001) (discussing systematic marketing to consumers' biases in the sale of mutual funds)
- Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U.L. REV. 1373 (2004) (credit card pricing based on consumer's overoptimism as to future spending patterns)
- REN S. ESSENE & WILLIAM APGAR, JT. CTR. FOR HOUSING STUDIES, HARVARD UNIVERSITY, UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS 25 (2007) (mortgage marketing relies on payment heuristic to steer consumers to expensive mortgage loans)
- Ting v. AT & T, 182 F. Supp. 2d 902 (N.D. Cal. 2002) (arbitration stuffer was designed by AT&T so as not to be read by consumers)

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Chairman Ben S. Bernanke
Vice Chairman Donald L. Kohn
Governor Kevin M. Warsh
Governor Randall S. Kroszner
Governor Frederic S. Mishkin

Dear Governors:

We were pleased to learn at October's Consumer Advisory Council meeting that the Board is considering, as part of its HOEPA rulemaking initiative, requiring early disclosures for non-purchase money loans. We are very concerned, however, that this new requirement will be rendered meaningless by a failure to correct the existing early disclosure rules.

At present, if an early disclosure becomes inaccurate, the creditor need only provide a corrected disclosure *at closing*. Reg. Z § 226.19(a)(2). At that point, even if the consumer notices the corrected disclosure amid the mass of documents presented at closing, the consumer's time for shopping for credit or backing out of the loan has passed.

In our experience, most early disclosures bear little resemblance to the terms of the loan that is actually presented to the consumer at closing. Whether this is because they are given so early in the process that the lender's estimates turn out to be inaccurate in the normal course of events, or because the lender is using bait-and-switch tactics, is irrelevant. The fact is that, despite the existing early disclosure rule for purchase money mortgage loans, the consumer does not get information about the actual terms of the loan until it is too late to do any good. If the Board broadens the early disclosure rule without correcting this problem, the new rule will likewise do no good.

We strongly recommend that the Board add a requirement that, when estimated disclosures become inaccurate in closed-end home-secured transactions, corrected disclosures must be given before closing as well as at closing. We recommend that a new § 226.19(a)(3) be added to Regulation Z as follows:

> *If there are material changes in the terms disclosed in the early disclosures, the creditor shall disclose all the changed terms no later than seven days before consummation or settlement.*[1]

[1] A corresponding revision would need to be made to Reg. Z § 226.17)(f) and footnote 39.

A corresponding provision should be added to the Commentary that defines "material change" to include:

- any change in the annual percentage rate that exceeds 1/8 of 1 percentage point in a regular transaction or ¼ of 1 percentage point in an irregular transaction;
- any change from a fixed rate to a variable rate or from a variable rate to a fixed rate;
- the addition of a prepayment penalty;
- any change greater than 1% or $100, whichever is smaller, in the amount of the monthly payment, or any other change in the payment schedule;
- any change in the amount financed that exceeds 1% or $100, whichever is smaller;
- any change in the variable rate terms of a loan, such as changes in the margin (even if this would not translate into a change in the APR beyond the tolerance);
- a change from one type of ARM to another;
- any addition or elimination of a payment option or negative amortization feature;
- any change in the loan term.

This addition to Regulation Z is within the Board's authority under Section 105(a) of the Act, which allows the Board to promulgate regulations that implement Congressional mandates or fill in gaps where Congress was silent. In § 128(b)(2), Congress requires early disclosures for certain transactions within three days of application and at consummation if the early disclosures are not accurate. This provision does not prohibit additional disclosures at other times.

In addition, we ask that the Board incorporate this redisclosure requirement as part of the rule it is drafting under 15 U.S.C. § 1639(l)(2), which requires the Board to prohibit "acts or practices in connection with ... mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section... ." Giving pre-closing disclosures that *do not reflect the terms of the loan that is actually offered* is the quintessence of deception. This bait and switch ploy has been a key part of the predatory lending tactics that have led to the current subprime mortgage crisis. We ask the Board to include language along the following lines in a rule adopted under § 1639(l)(2):

> *Failure to comply with the redisclosure requirements of § 226.19(a)(3) is an unfair and deceptive act prohibited by this regulation.*[1]

Defining failure to comply with the redisclosure requirement as an unfair and deceptive practice under § 1639(l)(2) is particularly important since then consumers would have a remedy under § 1640(a) for noncompliance. Experience has shown that creditors are far

[1] As an alternative, the entire redisclosure requirement could be placed within a rule adopted under § 1639(l)(2). However, the regulatory scheme will be more transparent if the redisclosure requirement is located among the other rules regarding the timing of disclosures in mortgage transactions. In addition, if the Board confines its new rule under § 1639 to some subset of the mortgage market, placing the redisclosure requirement there would mean that consumers entering into mortgage transactions not covered by the new rule would still receive inaccurate early disclosures that were not corrected until closing.

more likely to comply with requirements that are enforceable by consumers than those that are not.

Finally, we ask that the Board define failure to comply with the redisclosure requirement as grounds for rescission, by amending Reg. Z § 226.23 note 48 to read:

> *The term "material disclosures" means the required disclosures of the annual percentage rate, the finance charge, the amount financed, the total payments, the payment schedule, the redisclosure requirements of section 226.19(a)(3), and the disclosures and limitations referred to in sections 226.32(c) and (d).*

Switching the terms of the loan at the last minute should be grounds for rescission.

Making these additions to Regulation Z would strengthen the potential use of the estimated disclosures for shopping, and would ensure that the consumer had the opportunity to examine the terms of the loan before becoming bound. Without changes along these lines, however, extending the requirement of early disclosure to non-purchase money mortgage loans will have no effect on the mortgage problems we are seeing.

Thank you for considering these views.

Sincerely,

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ISSUES RELATED TO REMEDIES AND ASSIGNEE LIABILITY IN THE TRUTH IN LENDING PROPOSED RULE

I. Actual Damages under § 1640(a)(1).

Problem: Proving entitlement to actual damages is impossible under the judicial standards for disclosure violations that have evolved over the last few years. They do not work at all for substantive violations. Must prove: consumer read the disclosures, understood the charges; would have sought a lower price had the disclosure been accurate; and would have obtained a lower price or would have foregone the transaction altogether if the disclosure had been accurate.

Solution: Comment on this issue in the Supplementary Information and indicate that a fraud detrimental reliance standard does not work. State that all TIL requirements are part of the contract, like the FTC Holder Rule. For disclosure violations, the standard already in TILA § 1640(b) (correction of error defense) makes sense. For substantive violations, loan should conform to what the consumer should have gotten or the creditor should pay the difference (the amount of the harm).

II. Recovery for violations of the proposed servicer rules.

Problem: Proposed Regulation Z § 226.36(d) places duties upon servicers to curb servicing abuses. However, sections 1640(a) and 1641 do not attach civil liability to servicers, only to creditors and assignees. Thus, consumers will have no right to enforce these important duties.

Solution: The regulation should make clear that "no creditor or assignee, through its servicer, shall..." Servicers are the agents of the creditors, when the loans are held in portfolio, or are agents of the holder or trustee when they are sold. Those entities are primarily responsible for the acts of their servicers. They should be held liable for their failure to comply with the proposed rule. If liability attached to them, they would police these entities carefully to ensure compliance, a desirable goal. These duties should be included in or deemed a part of the loan contract.

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III. Assignee liability: apparent on the face of the disclosure statement in § 1641(e).

Problem: Section 1641(e) contains a difficult standard to meet, particularly when the creditor violates the current and proposed substantive rules. For example, an assignee could not determine that the lender had a pattern or practice of making loans without adequately assessing the consumer's ability to repay if it only looked at the TIL disclosure.

Solution: State in the Supplementary Information that "apparent on the face of the disclosure" in the context of the substantive protections in Regulation Z §§ 226.32, 226.34, 226.35, 226.36 means the entire loan file.

IV. Rescission for failure to provide the early TIL disclosure.

Problem: The TILA rescission remedy applies to the failure to give an accurate *final* TIL disclosure. The proposed rules do not extend rescission to the failure to give the *early* TIL disclosure. Creditors will have little incentive to comply with the proposed early TIL disclosure rule if damages alone are available, given the current state of the law on this, as discussed above. Creditors rarely give the RESPA good faith estimate in a timely way in the subprime market because there is no private right of enforcement under that law.

Solution: Amend Regulation Z § 226.23 n. 48 to define the early disclosure as a "material disclosure" for purposes of rescission in non-purchase mortgage loans.