Office of Thrift Supervision
Department of the Treasury

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December 18, 2009

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

SUBJECT: Comments on Proposed Amendments to Regulation Z
Docket No. R-1366

Dear Ms. Johnson:

The Office of Thrift Supervision (OTS) has reviewed the Federal Reserve Board's proposed amendments to Regulation Z concerning closed-end credit. We are encouraged by the many aspects of the August 26, 2009 proposed rule that provide consumers with greater protections in the mortgage origination process. To provide assistance with this effort, we have enclosed our comments on the proposed rule.

If you have any questions regarding our comments, please contact April Breslaw, Consumer Regulations Director at (202) 906-6989; Rhonda Daniels, Senior Compliance Program Analyst at (202) 906-7158; or Richard Bennett, Senior Compliance Counsel at (202) 906-7409.

Sincerely.

Montrice Godard Yakimov

Enclosure

Office of Thrift Supervision
Staff Commentary on Proposed Regulation Z Amendment
FRB Docket R-1366

The Office of Thrift Supervision (OTS) is taking this opportunity to comment on revisions to Regulation Z requirements for closed-end mortgage transactions proposed by the Board of Governors of the Federal Reserve System (the Board).[1] Through this rulemaking, the Board has proposed substantive protections for consumers that would limit loan originator compensation and prohibit certain forms of steering. The Board has also proposed changes to the closed-end credit disclosures governed by Regulation Z.

Discussion

Proposed Prohibition on Payments to Loan Originators

Under the proposal, a "loan originator" would include both mortgage brokers and employees of creditors who perform loan origination functions. The proposal would prohibit, in connection with a consumer credit transaction secured by real property or a dwelling, payments to a loan originator based directly or indirectly on any of the transaction's terms or conditions. Under one option, the principal amount of credit extended would be deemed a transaction term or condition that could not form the basis of a loan originator's compensation. Under the other option, it would not. For these types of consumer transactions, the Board has also proposed to prohibit a loan originator from steering a consumer to a transaction that is not in the consumer's interest in order to increase the broker or loan originator's compensation.

OTS supports the Board's proposal to prohibit compensation to a loan originator that is based on a loan's terms or conditions. We believe that a loan originator should not have an incentive to offer a loan that is more expensive than other products for which a borrower would qualify. As the Board noted in its proposal, a creditor payment to a mortgage broker based on the interest rate of the loan, provides an incentive to provide consumers loans with higher interest rates.[2]

Such a payment is known as a "yield spread premium."[3] While, in theory, a consumer can use a yield spread premium to buy down upfront origination charges, yield spread premiums are not always used to offset a consumer's origination and settlement costs. In fact, several studies have found that yield spread premiums are often used for the originator's benefit, rather than for the consumer's benefit.[4] There is extensive evidence to indicate that borrowers whose loans include a yield spread premium pay in

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[1] 74 Fed. Reg. 43232 (Aug. 26, 2009).
[2] 74 Fed. Reg. at 43280.
[3] An analogous payment made by a creditor to its employee is known as an "overage."
[4] See U.S. Department of Housing and Urban Development (HUD), Real Estate Settlement Procedures Act (RESPA): Rule To Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs, 73 Fed. Reg. 68204, 68260 (Nov. 17, 2008).

the aggregate more in fees, interest and other closing costs than other borrowers.[5] Yield spread premiums encourage brokers to steer borrowers to costly loans with abusive features. In fact, yield spread premiums may create the incentives that drive disparate pricing of mortgage loans that is based on illegal discrimination. Board research on subprime lending indicates that minorities receive a disproportionate level of high cost loans, even when they qualify for a prime loan.[6]

OTS recommends that the Board treat the principal amount of credit extended as a "term or condition" of the transaction. We can see no sound policy basis for providing loan originators with financial incentives to offer consumers larger loans than they may have requested. Based on our supervisory experience, doing so may create unnecessary credit risk for lenders, especially when a transaction has a discounted initial rate but is subject to payment increases after the introductory period expires. Therefore, the amount of a loan should be deemed a "term or condition" of the transaction on which loan originator compensation may not be based.[7]

Proposed Prohibition Against Steering

When choosing among loan products offered by one creditor, the restrictions on loan originator compensation discussed above are intended to eliminate the originator's incentive to direct a consumer to higher cost options. However, the proposed restrictions do not eliminate an originator's incentive to steer all consumers to the products offered by the creditor that provides the largest compensation for all transactions. The Board has therefore proposed, in connection with a consumer credit transaction secured by real property or a dwelling, to prohibit a loan originator from steering a consumer to a transaction that is not in the consumer's interest in order to increase the loan originator's compensation.[8]

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[5] See "Steered Wrong: Brokers, Borrowers, and Subprime Loans," Keith Ernst, Debbie Bocain and Wei Li, Center for Responsible Lending, April 2008, pp 4-5, 14, 16, 34-37, available at http://www.responsiblelending.org/mortgage-lending/research-analysis/steered-wrong-brokers-borrowers-and-subprime-loans.pdf ; "Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages," Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, Center for Responsible Lending, May 31, 2006, pp. 20-21, available at http://www.dhcd.virginia.gov/VFPTF/Reports/race_and_ethnicity.pdf; Jackson, Howell E. and Jeremy Berry, "Kickbacks or Compensation: The Case of Yield Spread Premiums,", pp. 7-8, available at: http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf; Opening Statement of Chairman Paul S. Sarbanes, U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums," Jan. 8, 2002, available at: http://banking.senate.gov/02_01hrg/010802/sarbanes.htm.

[6] See Avery, R.B. & Canner, G.B. (2005), "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," Federal Reserve Bulletin, 344-394; Avery, R.B., Brevoort, K.P. & Canner, G.B. (2006), "Higher-Priced Home Lending and the 2005 HMDA Data," Federal Reserve Bulletin, A123-A166; Avery, R.B., Brevoort, K.P. & Canner, G.B. (2007); "Opportunities and Issues in Using HMDA Data," Journal of Real Estate Research, 29(4), 351-379; Avery, R.B., Brevoort, K.P. & Canner, G.B. (2008), "The 2007 HMDA Data," Federal Reserve Bulletin Dec. 2008..

[7] OTS also recommends that the proposed commentary be clarified to include the following as examples of a "term or condition": whether the loan has a fixed or adjustable interest rate; the term of the loan; and the type of loan, e.g., purchase or refinance.

[8] Proposed 12 C.F.R. § 226.36(e)(1), 74 Fed. Reg. at 43332.

Under the proposal, a safe harbor would be created if the loan was chosen by the consumer from at least three loan options for each type of transaction in which the consumer expressed an interest, provided certain conditions are met. Notably, the proposed rule does not clarify how or when such options are to be presented to the consumer or explain why three options are necessary. For example, providing one option that has a lower interest rate than the loan offered would allow the consumer to comparison shop and avoid being steered to a particular loan product.

The OTS supports the proposed prohibition against steering. We believe that it would supplement provisions of the fair lending laws that prohibit discrimination on a prohibited basis.[9] Such discrimination can occur when qualified borrowers who are members of a protected class are steered into higher cost loans – a scenario which has prompted the OTS to make several referrals to the Department of Justice. However, we are concerned that the proposed "safe harbor" may not achieve its intended purpose. We therefore recommend that this provision be revised.

Recommended Alternative to Proposed Safe Harbor Provision

Pursuant to the Real Estate Settlement Procedures Act (RESPA) rules that take effect on January 1, 2010, all loan originators will be required to provide consumers with a standardized Good Faith Estimate (GFE) within three business days of receiving an application for a federally related mortgage loan.[10] The standardized GFE includes an optional trade-off table that allows a loan originator to provide information about a loan with a lower interest rate and a loan with lower settlement charges along with information about the loan set forth in the GFE. While the primary purpose of the trade-off table is to ensure that consumers understand there is a trade-off between interest rates and settlement costs, it can also help a consumer become aware of alternative loan products and thereby mitigate any attempt by a loan originator to steer the consumer to a higher cost loan.[11]

Accordingly, OTS recommends that in lieu of the proposed safe harbor provision, the Board provide that completion of the trade-off table on the standardized GFE constitutes a safe harbor for purposes of the steering provision. Such a safe harbor would ensure that consumers are provided with sufficient information to choose a loan that is in their best interest, but would be less burdensome to implement than the complicated safe harbor proposed by the Board. Moreover, a safe harbor based on the standardized GFE would further the goal of harmonizing TILA and RESPA disclosures – a result that would benefit all parties, including consumers.

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[9] Fair Housing Act, 42 U.S.C. 3601 *et seq.*; Equal Credit Opportunity Act, 15 U.S.C. 1691 *et seq.*

[10] 73 Fed. Reg. at 68240.

[11] If our recommended alternative is not adopted, we recommend that the Board clarify whether it would violate § 226(e) for an originator to steer a consumer into refinancing his or her loan instead of taking out a second lien based on the amount of compensation.

Proposed Calculation of the Finance Charge

General Rule for Third Party Charges

Regulation Z currently permits creditors to exclude several types of fees or charges from the calculation of the finance charge.[12] To simplify this calculation, the Board proposes to require that the finance charge include certain charges by a third party that are now excluded. Under the Board's proposal, third party charges would be part of the finance charge if the creditor requires use of the third party as a condition of the extension of credit, or if the creditor retains a portion of the third-party charge. Third party charges that would be incurred in a comparable cash transaction, such as transfer charges, would continue to be excluded from the finance charge.

OTS supports the Board's proposed approach to the calculation of the finance charge. We believe that consumers would benefit from having a finance charge that better represents the cost of credit, without excluding various fees and charges. In addition, the approach would simplify and reduce the compliance burden for OTS regulated institutions.

Special Rules for Voluntary Credit Insurance and Debt Cancellation or Suspension Fees

Currently, creditors may exclude the cost of credit insurance or debt cancellation or debt suspension coverage from the finance charge if the creditor discloses the voluntary nature and cost of the product and documents the consumer's affirmative request for the product. For closed-end transactions secured by real property or a dwelling, the Board proposes requiring that these fees be included in the finance charge. The Board would also require creditors to evaluate a consumer's age and/or employment status at the time of enrollment, and based on that review, represent that the consumer would be eligible to receive benefits.

Alternatively, for open-end transactions and closed-end transactions not secured by real property, the proposal would continue to permit creditors to exclude the cost of credit insurance or debt cancellation or debt suspension coverage from the finance charge as long as certain requirements are met. For reasons that are not clear, the requirements for <u>ex</u>cluding these fees from open end and unsecured closed end transactions are similar to those required when these fees are <u>in</u>cluded in the finance charge for closed end transactions secured by real estate. Thus, the proposal would require that a creditor determine, at the time of enrollment, that a consumer meets any applicable age or employment eligibility criteria for the product.

From our perspective, the fees for voluntary credit insurance and voluntary debt cancellation and debt suspension coverage should be included in the finance charge

[12] These include certain fees or charges imposed by third party closing agents; certain premiums for credit or property insurance; fees for debt cancellation or debt suspension coverage, if the creditor meets certain conditions; security interest charges; and real estate related fees such as title examination or document preparation fees. <u>See</u> 12 C.F.R. § 226.4.

regardless of whether the credit transaction is open-end or closed-end or whether the loan is secured by real property, or not. Given the significant costs of credit insurance products and the potential for abuse in the marketing and sale of such products,[13] such fees should always be included in the finance charge.

In addition, for all open-end and all closed-end transactions, OTS recommends that the final rule require the creditor to determine that the consumer meets the age and/or employment requirements at the time of enrollment. A determination of age or employment eligibility should not be unduly burdensome for a creditor because in most cases, the creditor would already have information about the consumer's age or employment status as part of the underwriting process. For all credit transactions, consumers should be assured that they meet these eligibility requirements before they purchase credit insurance or debt cancellation or debt suspension coverage.

Disclosures

Overall Observations

The OTS supports the use of concise new disclosures when a consumer is shopping for a mortgage, i.e., before an application fee has been paid. All of the financial institution regulatory agencies endorsed this strategy when we issued model illustrations for non-traditional and hybrid adjustable rate mortgages (ARMs).[14] We also support the use of new consumer tested disclosures at application that provide fundamental information about mortgage transactions, as well as new disclosures that offer more specific information about a consumer's transaction within three days after an application has been submitted. All of these proposed revisions to the required closed-end mortgage disclosures will improve consumers' ability to make informed credit decisions.

However, the approach to certain particularly complicated terms warrants additional consideration. First, it does not appear that the Board has tested whether the proposed disclosures are effective in helping consumers understand balloon payments and interest only payment arrangements. Such testing should be conducted. Second, while we understand that the Board has revised the way in which option ARM transactions are disclosed based on consumer reaction to the model illustrations developed by all of the agencies,[15] the revised disclosure should be tested with consumers to confirm that it has addressed the concerns that consumers raised.[16]

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[13] See The Money Tree, No. C3735 (F.T.C. Apr. 28, 1997) (settling allegations that credit insurance and other "extras" were required but not included in finance charge and APR disclosures in violation of the TILA and, in certain instances, the FTC Act); Tower Loan of Mississippi, 115 F.T.C. 140 (1992); Medine, David, FTC Bureau of Consumer Protection, Testimony before the House Committee on Banking and Financial Services, hearing on Predatory Lending Practices in the Subprime Industry, May 24, 2000, available at: http://www.ftc.gov/os/2000/05/predatorytestimony.htm.

[14] 72 Fed. Reg. 31825 (June 8, 2007), 73 Fed. Reg. 30997 (May 29, 2008).

[15] See 74 Fed. Reg. 43274, ftn. 45.

[16] It appears that such testing has been conducted with respect to the way in which negative amortization is explained. While negative amortization is a difficult concept for consumers, it appears that the revised

In addition, the need for additional research seems particularly acute with respect to introductory interest rates. As the Board noted, consumer testing revealed that many participants did not understand the ramifications of this feature.[17] In fact, several different disclosures designed to show the impact of an introductory rate were tested in tabular form, with mixed results. Consequently, the Board proposes to require an explanation of the introductory rate below the table itself.[18] Because introductory rates appear to be the source of substantial confusion, we strongly encourage the Board to test the proposed explanation with consumers before incorporating it into the final model disclosures.

With respect to eligibility requirements that go beyond age or employment for the credit insurance and debt cancellation or debt suspension coverage discussed above, the OTS recommends that the Board require a disclosure that explains such restrictions in a meaningful way in both open and closed-end transactions. Most importantly, consumers should be apprised that they may not qualify for coverage based on pre-existing conditions. The disclosure that the Board has proposed for use in some transactions: "You may not qualify to receive any benefits because of other eligibility restrictions" [19] is simply too vague. OTS recommends that a more understandable notice be developed and tested to determine whether it conveys information about eligibility restrictions in a manner that allows consumers to use it effectively.

Last, OTS supports the Board's effort to improve the quality and timing of notices provided after a consumer mortgage transaction has been consummated. We endorse the proposal to provide consumers with earlier notice of rate increases, and where a consumer has the option of remitting a payment that will not amortize a loan, we agree that the consumer should be provided with a table that graphically explains the consequences of doing so. As you know, the financial regulatory agencies expressed concern about whether consumers understand how negatively amortizing loans function in the Interagency Guidance on Nontraditional Mortgage Product Risks.[20] The OTS supports the Board's effort to codify the disclosure recommendations made in this guidance. We also endorse the model payment option table that the Board has proposed, as it is similar to the sample illustrations that the agencies suggested.[21]

Comments on Adjustable Rate Mortgage (ARM) Disclosure Requirements

The proposal would require that creditors provide ARM loan program disclosures at application or before the consumer pays a nonrefundable fee (whichever is earlier) that include a "Key Questions About Risk" section to allow consumers to become aware of

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transaction-specific plain-language explanation of negative amortization's causes and effects is generally understood when disclosed in the "key questions" format. See 74 Fed. Reg. 43267.

[17] 74 Fed. Reg. at 43301.

[18] Id.

[19] 74 Fed. Reg. at 43249.

[20] 71 Fed. Reg. 58609, October 4, 2006.

[21] 72 Fed. Reg. at 31831.

potentially risky features of their loans.[22] In this section, creditors would always be required to disclose information about rate increases, payment increases, and prepayment penalties.[23] In contrast, creditors would only be required to disclose information about the following six terms if they are applicable to the loan program: interest-only payments, negative amortization, balloon payments, demand features, no-documentation or low-documentation loans, and shared-equity or shared-appreciation.[24] Apparently, this difference is attributable to the Board's concern about the potential for information overload if the entire list were to be included on every ARM loan program disclosure.[25]

No later than three business days before consummation, the proposal would also require creditors to provide consumers with a final ARM program disclosure that includes information about rate increases, monthly payment increases, prepayment penalty, as well as information about the six terms listed above, if applicable, with the actual amounts filled in.[26]

In this case, the benefit of being judicious about the information provided to consumers is outweighed by the confusion that lack of information may cause. Specifically, it is important that a consumer be able to directly compare the "Key Questions About Risk" portion of the early disclosures with the "Key Questions About Risk" portion of the final disclosures. Such a comparison will be more difficult if the early ARM loan program disclosures do not affirmatively state that a loan does not involve interest-only payments, negative amortization, balloon payments, demand features, no-documentation or low-documentation loans, or shared-equity or shared-appreciation, as applicable. Absent such information in the early ARM loan program disclosure, a consumer that received a later disclosure indicating that such features are part of his or her transaction could be vulnerable to misleading explanations from the lender about the change in terms. Notably, the Board's consumer testing demonstrated that some consumers would be reassured by having all loan features presented on the early disclosure, whether they were a feature of their loan or not.[27]

Disclosures Three Days Before Consummation

Under current requirements, a creditor is required to provide the early TILA disclosure to a consumer within three business days after receiving the consumer's written application and at least seven business days before consummation, and before the consumer has paid any fee other than a fee for obtaining a credit history. If the APR on the early TILA disclosure exceeds a certain tolerance before consummation, the creditor must provide a corrected disclosure that the consumer must receive at least three business days before consummation. If any term other than the APR becomes inaccurate, the creditor must give the corrected disclosure no later than at consummation.

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[22] Proposed 12 C.F.R. § 226.19(b)(2) and (d), 74 Fed. Reg. at 43328-29.
[23] Proposed 12 C.F.R. § 226.19(b)(2)(i).
[24] Proposed 12 C.F.R. § 226.19(b)(2)(ii).
[25] 74 Fed. Reg. at 43266.
[26] Proposed 12 C.F.R. §§ 226.19(a)(2)(ii) and 226.38(d), 74 Fed. Reg. at 43326 and 43335-36.
[27] 74 Fed. Reg. at 43266.

The proposed rule would require the creditor to provide a final TILA disclosure at least three business days before consummation, even if nothing changed since the early TILA disclosure was provided.[28] OTS supports this proposal. A consumer who receives notice of changed loan terms at closing does not have a meaningful opportunity to make an informed credit decision. While the proposed change may require creditors to modify current settlement practices, consumers will certainly benefit from receiving a final TILA disclosure at a point in time when it will be useful.

The Board also proposed two alternative approaches to address changes to loan terms and settlement charges that occur within three days before consummation. Under the first approach, if any terms change during the waiting period, the creditor would be required to provide another final TILA disclosure and wait an additional three business days before consummation could occur. Under the second approach, creditors would be required to provide another final TILA disclosure, but would have to wait an additional three business days before consummation only if the APR exceeds a designated tolerance or if the creditor adds an adjustable-rate feature.

OTS supports an additional three business day waiting period before consummation if the APR changes beyond the specified tolerance, or if significant additional terms or features are added to the loan. These include the "Key Terms" required to be disclosed for ARM loans: an adjustable rate, interest-only payment features, negative amortization, a prepayment penalty, demand features, shared-equity or shared-appreciation, or a balloon payment. Such an approach would ensure that consumers have the opportunity to investigate significant changes to loan terms, but would prevent minor changes from repeatedly delaying loan consummation.

[28] Proposed 12 C.F.R. § 226.19(a)(2)(iii), 74 Fed. Reg. at 43326.