

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of Consumer and Community Affairs

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**Date:** November 27, 2001  
**To:** Board of Governors  
**From:** Governor Gramlich, Chairman  
Committee on Consumer and Community Affairs  
**Subject:** Amendments to Regulation Z addressing concerns related to predatory practices in mortgage lending

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

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**Date:** November 27, 2001  
**To:** Board of Governors  
**From:** Division of Consumer and Community Affairs  
(D. Smith and staff)<sup>1</sup>  
**Subject:** Amendments to Regulation Z addressing concerns related to predatory practices in mortgage lending

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**ACTION REQUESTED:** Approval to publish a final rule amending the provisions of Regulation Z that implement the Home Ownership and Equity Protection Act to address concerns related to predatory practices in mortgage lending.

**SUMMARY**

Since the mid-1990s, the subprime mortgage market has grown substantially, providing access to credit to borrowers with less-than-perfect credit histories and to borrowers who are not served by prime lenders. With this increase in subprime lending there has also been an increase in reports of “predatory lending.” The term “predatory lending” encompasses a variety of practices. In general, it is used to refer to abusive lending practices involving fraud, deception, or unfairness. Some abusive practices are clearly unlawful, but others involve loan terms that are legitimate in many instances and abusive in others, and thus are difficult to regulate. Loan terms such as balloon payments, for example, may benefit some borrowers, but may harm other borrowers, particularly if they are not fully aware of the consequences. The reports of predatory lending have generally included one or more of the following practices:

- Making unaffordable loans based solely on the borrower’s home equity without regard to the borrower’s ability to repay the obligation.
- Inducing a borrower to refinance a loan repeatedly, even though the refinancing may not be in the borrower’s interest, and charging high points and fees each time the loan is

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<sup>1</sup> A. Hurt, J. Michaels, J. Ahrens, D. Loneragan, and M. Le.

refinanced (“loan flipping”). As the loan balance increases due to the financed fees, the consumer’s equity in the home decreases (“equity stripping”).

- Engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower—for example, “packing” loans with credit insurance without consumers’ consent.

In response to anecdotal evidence about abusive practices involving home-secured loans with high rates or high fees, in 1994 the Congress enacted the Home Ownership and Equity Protection Act (HOEPA). HOEPA amended the Truth in Lending Act (TILA) and applies to closed-end home-equity loans (excluding home-purchase loans) bearing rates or fees above a specified percentage or amount. For covered transactions, HOEPA imposes substantive limitations, such as restrictions on short-term balloon notes and prepayment penalties, and additional disclosure requirements. Under the rate-based trigger, a loan is covered by HOEPA if at the time of consummation the annual percentage rate (APR) exceeds by more than 10 percentage points the yield on Treasury securities having a comparable maturity. Under the fee-based trigger, a loan is covered if the total points and fees exceed 8 percent of the loan amount or \$400, whichever is greater.<sup>2</sup>

HOEPA authorizes the Board to adjust both price triggers. The Board may adjust the APR trigger by up to 2 percentage points from the current standard of 10 percentage points upon a determination that the increase or decrease is consistent with the consumer protections against abusive lending contained in HOEPA and is warranted by the need for credit. The Board may adjust the fee-based trigger by including additional fees, not by adjusting the percentage. The act also authorizes the Board, for all mortgage loans, to prohibit acts or practices that are unfair, deceptive, or designed to evade HOEPA. For refinancings, the Board is also authorized to prohibit

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<sup>2</sup> HOEPA established a \$400 amount that is adjusted annually based on the Consumer Price Index. The dollar figure for 2001 is \$465 and for 2002 is \$480.

acts or practices associated with abusive lending practices or that are otherwise not in the borrower's interest.

Last year, the Board held hearings in four cities to consider how it might use its authority under HOEPA to deter predatory lending practices. In the Federal Register notices announcing the hearings, the Board posed questions on the need to adjust HOEPA's rate and fee triggers; it also sought comments on other topics including restricting certain acts or practices such as "insurance packing," the refinancing of subsidized low-rate loans into high-rate loans, steering borrowers eligible for prime credit to subprime loan products, making loans to borrowers unable to repay, and failing to report a subprime borrower's good payment record to credit bureaus. The Board's notices also included questions about setting minimum federal standards for foreclosures, mandating credit counseling for certain borrowers, and requiring additional cost disclosures. The staff analyzed the many suggestions offered in connection with the Board's hearings as well as recommendations for regulatory action made in a report by the Department of Housing and Urban Development (HUD) and the Department of Treasury (Treasury) to the Congress.

In December 2000, the Board published for public comment a proposal to amend Regulation Z. The proposed amendments: (1) extended the protections of HOEPA to more loans; (2) prohibited certain acts or practices; (3) strengthened HOEPA's prohibition on loans based solely on homeowners' equity without regard to repayment ability; and (4) enhanced HOEPA disclosures received by consumers before closing.

The Board received more than 1,300 comments; approximately 1,100 of these were identical e-mail messages. Most of the creditors and other industry commenters opposed making more loans subject to HOEPA. They believed that the coverage of more loans would reduce competition and the availability of credit in the range of rates affected because certain lenders will not make HOEPA loans. With regard to other rules in the proposal, creditors wanted more

flexibility and compliance guidance. Representatives of consumers and community development organizations generally supported the proposal as a minimal first step toward addressing the problem of predatory lending but believed additional consumer protections are needed.

After analyzing the comments received, the staff recommends that the Board publish a final rule amending Regulation Z as set forth below. The draft final rule is substantially similar to the proposed rule, with two exceptions. The staff recommends lowering the APR trigger only for first-lien mortgage loans. The staff also recommends dropping the proposal to restrict the refinancing of subsidized low-rate loans into high-rate loans; the benefit to borrowers protected by such a rule appears to be far outweighed by the potential compliance burden for refinancings generally. A draft Federal Register notice on the recommended final rule is attached beginning at page 31. In summary, the draft final rule would do the following:

**1. Extend HOEPA's protections to more loans**

- Adjust the APR trigger for first-lien mortgage loans, from 10 percentage points to 8 percentage points above the rate for Treasury securities having a comparable maturity, the maximum amount that the Board may lower the trigger. The APR trigger for subordinate-lien loans would remain at 10 percentage points.
- Adjust the fee-based trigger to include amounts paid at closing for optional credit life, accident, health, or loss-of-income insurance and other debt-protection products.

**2. Prohibit specific acts or practices**

- Address “loan flipping” within the first twelve months of a HOEPA loan. A creditor that has made a HOEPA loan to a borrower in the preceding twelve months would generally be prohibited from refinancing another HOEPA loan to the same borrower (whether or not the creditor still holds the loan). A creditor would be permitted to make such a loan if it is “in the borrower’s interest.” Assignees holding or servicing a HOEPA loan would be covered by this rule as if they were the original creditors.
- Prevent evasions of HOEPA, which only covers closed-end loans, by prohibiting a creditor from wrongfully documenting them as open-end credit. For example, a high-cost mortgage could not be structured as a home-secured line of credit if there is no reasonable expectation that repeat transactions will occur under a reusable line of credit.
- To ensure that lenders do not accelerate the payment of HOEPA loans without cause, prohibit a creditor from exercising “due-on-demand” or “call” provisions in a HOEPA

loan, unless the clause is exercised in connection with the consumer's default. A similar rule applies to home-secured lines of credit.

### **3. Strengthen enforcement of HOEPA's prohibition on unaffordable lending**

- Create a presumption that a creditor has violated the statutory prohibition on making HOEPA loans without regard to repayment ability, if the creditor generally does not verify and document consumers' repayment ability.

### **4. Enhance disclosures**

- Revise the HOEPA disclosure (given three days before loan closing) in refinancings to alert consumers to the total amount borrowed, which may be substantially higher than the loan amount requested by the borrower due to the financing of insurance, points, and fees. To enhance consumer awareness, and deter "insurance packing," the HOEPA disclosure would have to specify whether the total amount borrowed includes the cost of optional insurance.

## **BACKGROUND**

### **The Home Ownership and Equity Protection Act**

In 1994, HOEPA was enacted as an amendment to TILA. HOEPA was a response to anecdotal reports of abusive lending practices involving unscrupulous lenders who made unaffordable home-secured loans to "house-rich but cash-poor" borrowers.<sup>3</sup> Frequently, elderly and sometimes unsophisticated homeowners were targeted for loans with high rates and fees and repayment terms that were difficult or impossible for the homeowners to meet. Oftentimes the transactions involved fraud or misrepresentations by creditors or brokers.

HOEPA identifies a class of high-cost mortgage loans through rate and fee triggers, and it provides consumers entering into these transactions with special protections. Creditors offering HOEPA-covered loans must give consumers an abbreviated disclosure statement at least three business days before the loan is closed, in addition to the disclosures generally required by TILA at or before closing. The HOEPA disclosure informs consumers that they are not obligated to

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<sup>3</sup> For purposes of this memorandum, references to HOEPA generally apply to high-cost mortgages covered by HOEPA's rate or fee-based triggers. HOEPA also amended TILA to require additional disclosures for reverse mortgages.

complete the transaction and could lose their home if they take the loan and fail to make payments. It also provides a few key items of cost information, including the APR. In cases where consumers have three business days after closing to rescind the loan, the HOEPA disclosure thus affords consumers a minimum of six business days to consider key loan terms before the loan proceeds are disbursed.

HOEPA restricts certain loan terms for high-cost loans because they are associated with abusive lending practices. These terms include short-term balloon notes, prepayment penalties, non-amortizing payment schedules, and higher interest rates upon default. Creditors are prohibited from engaging in a pattern or practice of making HOEPA loans based solely on homeowners' equity without regard to their ability to repay the loan. Under HOEPA, assignees are generally subject to all claims and defenses with respect to a HOEPA loan that a consumer could assert against the creditor. HOEPA also authorizes the Board to prohibit acts or practices under defined criteria such as acts or practices that are unfair or otherwise not in the interest of the borrower.

### **Continued Concerns About Predatory Lending Practices**

Since the enactment of HOEPA in 1994, the volume of home-equity lending has increased significantly in the subprime mortgage market. Data reported under the Home Mortgage Disclosure Act show that the number of nonpurchase-money loans made by lenders identified as subprime lenders increased about five-fold—from 138,000 in 1994 to roughly 658,000 in 2000. The substantial growth raises the concern that with the increase in the number of subprime loans, there has been a corresponding increase in the number of predatory loans.

In the past two years, various initiatives to address predatory lending have been undertaken. The Senate Banking Committee held hearings in July 2001 at which consumers and representatives of industry and consumer groups testified, and the House Banking Committee held hearings in

May 2000 at which the banking regulators and others testified. Bills have been introduced in the Congress to address predatory lending practices, but no action has been taken on them.<sup>4</sup> Several states and municipalities have enacted or are considering legislation or regulations.<sup>5</sup> HUD and Treasury held a number of public forums on predatory lending and issued a report in June 2000, making recommendations to the Congress regarding legislative action and to the Board urging the use of its regulatory authority to address predatory lending.<sup>6</sup> Fannie Mae and Freddie Mac published guidelines last year to avoid purchasing loans that are potentially predatory; for example, they will not purchase loans with single-premium credit insurance and will not purchase HOEPA loans. They are also making efforts to develop consumers' awareness of their credit options.

The staff has met with industry representatives, consumer advocates, and congressional staff and has conferred with the Board's Consumer Advisory Council on the issue of predatory lending. In 2000, the Board held hearings in Charlotte, Boston, Chicago, and San Francisco, to consider approaches the Board might take in exercising its regulatory authority under HOEPA.

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<sup>4</sup> The bills generally would (1) lower the APR trigger, typically below the rate that the Board is authorized to set, with bills divided equally between using the same and different triggers for first- and subordinate-lien loans; (2) include financed credit insurance premiums in the points and fees trigger or prohibit the financing of such premiums; and (3) limit the points and fees that can be charged in refinancings, or prohibit refinancings unless there is a "net benefit" to the consumer.

<sup>5</sup> Five states (North Carolina, California, Massachusetts, Illinois, and New York) have adopted high-cost loan statutes or regulations. The states have taken similar approaches: (1) four states use APR triggers lower than the current HOEPA trigger; three states use different triggers for first-and subordinate-lien loans; (2) five states prohibit the financing of single premium credit insurance or limit the amount of credit insurance that may be financed for certain borrowers; and (3) five states address loan flipping by limiting the fees creditors can charge or finance in refinancings, and in three of these states by prohibiting refinancings that do not benefit the borrower. The District of Columbia has prohibited certain practices on all home-secured loans regardless of cost but has suspended this law for four months to revise and clarify its provisions. Several cities and counties have adopted ordinances that prevent "predatory" lenders from doing business with the local government and, in two cases, impose substantive restrictions on high-cost mortgage loans. Only one such ordinance (Chicago) is in effect. Others (for example, Philadelphia, DeKalb County, and Dayton) have been stymied by preemptive state legislation or litigation.

<sup>6</sup> HUD and Treasury recommended lowering HOEPA's APR trigger, including in the HOEPA points and fees trigger single-premium credit insurance and yield spread premiums, prohibiting "loan flipping," providing additional

The Board's hearings focused on expanding the scope of mortgage loans covered by HOEPA, prohibiting specific acts or practices, improving consumer disclosures, and better educating consumers. In the notices announcing the hearings, the Board also solicited written comment on possible revisions to Regulation Z's HOEPA rules. The Board received approximately 450 comment letters in response to the notices, two-thirds of which were from consumers generally encouraging Board action to curb predatory lending.

### **The Board's Proposed Rule to Address Predatory Lending Practices**

The Board published a proposed rule in December 2000.<sup>7</sup> The proposal would broaden the scope of mortgage loans subject to HOEPA by adjusting the price triggers used to determine coverage under the act; would prohibit certain acts and practices in connection with home-secured loans covered by HOEPA; would require increased scrutiny of creditors' practices to document and verify income; and would enhance disclosures received by consumers before closing HOEPA-covered loans.

The Board received approximately 200 letters that specifically addressed the proposed revisions and represented the views of the mortgage lending industry, credit insurance industry, consumer and community development interests, and government agencies. In addition, the Board received approximately 1100 identical e-mail comment letters from consumers encouraging the Board to curb predatory lending.

Most of the creditors and other commenters involved in mortgage lending opposed making more loans subject to HOEPA. They believe that the coverage of more loans would reduce competition and the availability of credit in the range of rates affected because some lenders, as a matter of policy, will not make HOEPA loans. With regard to the new rules that would apply to

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guidance on the unaffordable lending provision of HOEPA, and restricting the sale of single-premium insurance products.

<sup>7</sup> 65 Fed. Reg. 81438 (Dec. 26, 2000).

HOEPA loans, creditors wanted more flexibility and compliance guidance. Consumer representatives and community development organizations generally supported the proposal as a step forward in addressing the problem of predatory lending, but believed additional consumer protections are needed.

### **The Draft Final Rule**

The staff recommends that the Board publish a final rule addressing predatory lending and unfair practices in the home-equity market, exercising the Board's authority under HOEPA. The draft final amendments would largely implement the proposal published last December, with two exceptions. The APR trigger would only be lowered for first-lien mortgage loans. Also, the proposal to restrict the refinancing of subsidized low-rate loans (such as Habitat for Humanity loans) into high-rate loans would be dropped due to the potential compliance burden for refinancings generally.

## **ISSUES FOR BOARD CONSIDERATION**

### **1. Extend the Scope of Mortgage Loans Subject to HOEPA's Protections**

HOEPA's disclosures and restrictions cover home-equity loans that meet one of the act's two "high-cost" triggers—a rate trigger and a fee trigger. The staff recommends revising both triggers to cover more loans.

Annual percentage rate. The Board proposed to reduce the rate trigger from 10 to 8 percentage points above the rate for Treasury securities with a comparable term for all loans, the maximum adjustment that the Board can make under the statute. With this change, based on recent rates for Treasury securities, home-equity loans with a term of ten years would be subject to HOEPA if they have an APR of approximately 13 percent or higher.

The Board solicited comment on an alternative approach that would differentiate between first- and subordinate-lien loans. Under the two-tiered alternative, the APR trigger for first-lien mortgages would be reduced to 8 percentage points; the APR trigger for subordinate-lien loans would remain at 10 percentage points. The staff recommends that the Board adopt the alternative approach.

HOEPA provides that the Board may adjust the APR trigger after consulting with representatives of consumers and lenders and determining that the increase or decrease is consistent with the purpose of consumer protection in HOEPA and is warranted by the need for credit. (The Board may not adjust the trigger more frequently than once every two years.) The Board has held public hearings, received and analyzed comment letters, held discussions with community groups and lenders, consulted the Consumer Advisory Council, and reviewed various studies and reports on the home-equity lending market.

Most of the information about predatory lending is anecdotal, as it was when Congress passed HOEPA in 1994. But the reports of actual cases (including additional Congressional testimony by consumers) are widespread enough to indicate that the problem warrants addressing. Homeowners in certain communities—frequently the elderly, minorities, and women—continue to be targeted with offers of high-cost, home-secured credit with onerous loan terms. The loans, which are typically offered by nondepository institutions, carry high up-front fees and may be based solely on the equity in the consumers' homes without regard to their ability to make the scheduled payments. When homeowners have trouble repaying the debt, they are often pressured into refinancing their loans into new unaffordable, high-fee loans that rarely provide economic benefit to consumers. These refinancings may occur frequently. The loan balances increase primarily due to fees financed resulting in reductions in the consumers' equity in their homes and,

in some cases, foreclosure may occur. The loan transactions also may involve fraud and other deceptive practices.

Creditors have expressed concern that lowering the HOEPA rate trigger would adversely affect credit availability for loans in the range of rates that would be covered by the lowered trigger. Many creditors, ranging from community banks to national lenders, have stated that they do not offer HOEPA loans due to their concerns about compliance burdens, potential liability, reputational risk, and difficulty in selling these loans to the secondary market. Some creditors believe there are insufficient data about the incidence of predatory lending occurring in loans immediately below the existing HOEPA triggers to support the proposed change.

Anecdotal evidence suggests that subprime borrowers with rates below the current HOEPA triggers have been subject to abusive lending practices. There are no precise data, however, on the number of subprime loans in the market as a whole that would be affected by lowering the HOEPA rate trigger. The precise effect of lowering the APR trigger on creditors' business strategies is difficult to predict. Some creditors that do not make HOEPA loans may withdraw from making loans in the range of rates that would be covered by the lowered threshold. But other creditors may fill any void left by creditors that choose not to make HOEPA loans, either because they already make HOEPA loans or are willing to do so in the future. And others may have the flexibility to avoid HOEPA's coverage by lowering rates or fees for some loans at the margins, consistent with the risk involved. Data submitted by a trade association representing non-depository institution lenders suggest that there is an active market for HOEPA loans under the current APR trigger. There is no evidence that the impact on credit availability will be significant if the trigger is lowered. Accordingly, the staff believes that lowering the APR trigger to expand HOEPA's protections to more loans is consistent with consumers' need for credit, and therefore, warranted.

Borrowers who have less-than-perfect credit histories and those who might not be served by prime lenders have benefited from the substantial growth in the subprime market. But a borrower does not benefit from expanded access to credit if the credit is offered on unfair terms, the repayment costs are unaffordable, or the loan involves predatory practices. Because consumers who obtain subprime mortgage loans have, or perceive they have, fewer options than other borrowers, they may be more vulnerable to unscrupulous lenders or brokers.

Lowering the rate trigger seeks to ensure that the need for credit by subprime borrowers will be fulfilled more often by loans that are subject to HOEPA's protections.<sup>8</sup> This action is consistent with the purpose of HOEPA, which is to protect vulnerable consumers based on the cost of the loan. If the rate trigger is lowered, more consumers with high-cost loans would receive cost disclosures three days before closing (instead of at closing) and would be protected by HOEPA's prohibitions against loan terms such as non-amortizing payment schedules, balloon payments on short-term loans, or interest rates that increase upon default. A wider range of high-cost loans would also be subject to HOEPA's rule against unaffordable lending, and to HOEPA's restrictions on prepayment penalties. Lastly, more high-cost loans would be subject to the HOEPA rule that holds loan purchasers and other assignees liable for any violation of law by the original creditor with respect to the mortgage.

Of the 200 commenters on the proposal, about 40 discussed the two-tiered trigger approach and were about evenly divided. Creditors and some consumer groups favored the two-tiered trigger approach. Those opposed to this approach included community groups, some creditors, and others that generally believe there should be no distinction drawn between first-lien and subordinate-lien loans. Community groups believe that the maximum number of subprime

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<sup>8</sup> There is also evidence that borrowers with loans covered by HOEPA are still subject to abusive practices not addressed by the current rules, such as loan flipping; these would be addressed by the proposed prohibitions on certain refinancing practices.

mortgage loans should be subject to HOEPA's protections.<sup>9</sup> Some creditors that opposed the tiered approach believe that the Board should not issue a rule that might encourage the making of loans that place creditors in a subordinate lien position. One institution noted that a subordinate-lien loan may not be more favorable to a consumer if it results in a combined monthly payment on the first and second mortgages that is higher than the monthly payment on a consolidated first-lien mortgage loan. Some commenters believe that borrowers with subordinate-lien loans face similar risks of abusive practices as with first-lien loans. A few asserted that the tiered approach would add unnecessary complexity to both compliance and enforcement efforts.

Data are not available on the number of home-equity loans currently subject to HOEPA, or the number of loans that would be covered if the APR trigger were lowered. At the time of the proposal, data from the Mortgage Information Corporation (MIC) compiled by the Office of Thrift Supervision suggested that lowering the APR trigger by two percentage points could expand HOEPA's coverage from approximately 1 percent to 5 percent of subprime mortgage loans. Analysis of additional MIC data suggests that these percentages of coverage may be typical of longer-term, first-lien mortgages, but that the coverage percentages are higher for shorter-term and subordinate-lien loans.

In response to the Board's request in the proposal, a few commenters provided data on the number of loans they offered in recent years that would have been affected if HOEPA's rate trigger stood at 8 percentage points above a comparable Treasury security. The most extensive data were submitted by a trade association representing non-depository institution lenders. The association collected data from the subprime lending divisions of nine member institutions, representing about 1.4 million loans made from July 1995 through June 2000. The number of

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<sup>9</sup> Community groups believed that the two-tiered approach could be helpful but only if both triggers were substantially lower than what the Board is authorized to adopt.

loans surveyed represent about 36 percent of the number of loans of subprime lenders recorded under the Home Mortgage Disclosure Act during the survey period, and represent approximately 20 percent of the total dollar volume of subprime loans made during this period. Overall, the trade association data show that for the loans surveyed, HOEPA's existing APR trigger covered about 9 percent of the first-lien loans, and that lowering the APR trigger by two percentage points would have resulted in coverage of nearly 26 percent of the first-lien loans. For subordinate-lien loans, about 47 percent were covered by HOEPA's existing APR trigger, and the data suggest that lowering the APR trigger by two percentage points would have resulted in coverage of about 75 percent of the subordinate-lien loans.

Most of the evidence of predatory lending involves abuses in connection with first-lien mortgage loans. When a consumer seeks a loan to consolidate debts or finance home repairs, some creditors require consumers also to borrow funds to pay off the existing first mortgage as a condition of providing the loan, even though the existing first mortgage may have been at a lower rate. This ensures that the creditor will be the senior lien-holder, but it also results in an increase, perhaps significant, in the dollar amount of points and fees paid for the new loan.

The draft final rule would leave the APR trigger for subordinate-lien mortgage loans at the current 10 percentage points above the rate for Treasury securities with a comparable term. Subordinate-lien loans are already covered by HOEPA more frequently than first-lien loans because the rates on these loans are typically higher than on first-lien loans. Although the Board's statutory authority to adjust the HOEPA APR trigger is not contingent upon statistical data analysis, the data from the MIC and from the trade association survey suggest that coverage under the current triggers already could be significant. Moreover, the evidence of abusive practices has mostly pertained to first-lien mortgage loans. Thus, the staff recommends that the Board issue a

final rule that lowers the APR trigger for first lien-mortgages only. This approach is a more measured step in expanding HOEPA's coverage in the subprime credit market.

Points and fees. Presently, home-equity loans are subject to HOEPA if the points and fees payable by the consumer at or before closing exceed the greater of 8 percent of the loan amount or \$465. "Points and fees" are defined in HOEPA but the act also authorizes the Board to add "such other charges as the Board determines to be appropriate."<sup>10</sup>

The comment letters and testimony at the hearings raised a number of concerns about single-premium credit insurance: excessive costs, high-pressure sales tactics, consumers' confusion as to voluntariness, and "insurance packing." The term "packing" in this case refers to the practice of automatically including optional insurance in the loan amount without the consumer's request; as a result, some consumers may perceive that the insurance is a required part of the loan, and others may be unaware that insurance has been included.

In response to the reported abuses, the Board proposed to include in the fee trigger premiums paid at closing for optional credit life, accident, health, or loss-of-income insurance and other debt-protection products that are typically financed.<sup>11</sup> The staff recommends that the Board adopt a final rule, as proposed.

Many commenters expressed views on this issue. The views were sharply divided. In general, consumer representatives, some federal agencies, state law enforcement officials, and some others supported the inclusion of optional credit insurance premiums in HOEPA's points and fees trigger, in the absence of an outright ban on the purchase or financing of single-premium

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<sup>10</sup> "Points and fees" include all finance charges—the fees that comprise the cost of the credit and are used in calculating the APR—except for interest. The trigger also includes some fees that are not finance charges, such as closing costs paid to the lender.

<sup>11</sup> Premiums paid for required credit insurance policies are considered finance charges under TILA and are already included in HOEPA's points and fees trigger.

products. Consumer representatives were generally concerned about the cost of the insurance, confusion about voluntariness, and its impact on equity stripping. They believe that borrowers are often unaware that insurance has been included in their loan balance or that borrowers perceive that the insurance is required. They also note that the problem exists notwithstanding the fact that TILA currently requires creditors to disclose to consumers that the insurance is optional in order to exclude it from the HOEPA fee trigger.<sup>12</sup> They state that excessively high premiums contribute to the problem of equity stripping. They also note that consumers pay interest on the financed premium for the entire loan term even though insurance coverage typically expires much earlier.

Most creditors and commenters representing the credit insurance industry strongly opposed the inclusion of optional insurance premiums in the points and fees trigger. Some creditors questioned the Board's authority under HOEPA to mandate inclusion, based on legislative history that discusses the potential inclusion of credit insurance premiums if there is evidence that credit insurance premiums are being used to evade HOEPA. These commenters believe that a finding of evasion is a prerequisite to inclusion; they do not believe the Board has satisfied that standard because the proposal merely notes that the change might prevent such evasions in the future. They also cited an exchange between two Senators, when the Congress was considering HOEPA legislation, about credit insurance being treated consistently with other provisions of TILA. Because premiums for optional credit insurance are not automatically included in the calculation of TILA's finance charge and APR, these commenters believe such premiums should not be included in HOEPA's points and fees calculation.

The commenters' suggestion that credit insurance premiums can only be included in the HOEPA trigger if the Board finds that creditors are using the premiums to evade HOEPA is

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<sup>12</sup> If creditors fail to disclose that the insurance is optional, TILA requires that the cost be treated as a finance charge, and all finance charges (except for interest) are in the current HOEPA fee trigger.

directly contradicted by the express language of the statute, which states that the Board need only make a finding that this action is “appropriate.” In construing a statute, the plain meaning of the statutory text generally governs. When the plain meaning of the statutory language is clear, the courts have held that there is no reason to resort to legislative history.<sup>13</sup> In light of the unambiguous statutory text, the staff believes that the legislative history cited by the commenters is not dispositive, and that evasion is merely one example of when the Board might find that inclusion of additional charges is “appropriate.”<sup>14</sup>

Industry commenters opposed including optional credit insurance premiums in HOEPA’s points and fees trigger when, for purposes of TILA disclosures generally, the premiums are not included in the cost of the credit. The staff believes that HOEPA’s points and fees trigger is not intended to be the equivalent of the “cost of credit,” as measured by TILA’s finance charge and APR. Indeed, HOEPA expressly includes certain charges in the points and fees trigger that are not included in the finance charge, and authorizes the Board to include others.<sup>15</sup> HOEPA’s points and fees trigger is intended to be used to identify transactions with high costs where consumers may be vulnerable and thus need the benefit of HOEPA’s special protections.

Creditors also assert that, based on typical premium rates, most mortgage loans that include single-premium credit insurance would be considered high-cost and thus would be covered under

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<sup>13</sup> Moreover, if the Congress had intended to make “evasions” the sole standard of “appropriateness” for including additional charges in the fee trigger, it would have done so expressly. For example, such language was used in section 129(l)(2)(A), which authorizes the Board to prohibit acts and practices that the Board finds to be “unfair, deceptive, or designed to evade” the provisions of HOEPA.

<sup>14</sup> The Senate floor colloquy, cited by commenters, which refers to HOEPA as being consistent with TILA’s treatment of insurance premiums, should not be construed as guidance on how the Board may, in the future, adjust HOEPA’s points and fees trigger. It merely clarified that optional credit insurance premiums were not automatically included in the statutory points and fees trigger, as would have been the case in an earlier version of the legislation.

<sup>15</sup> HOEPA’s fee-based trigger includes closing costs paid to the creditor or an affiliate although these are excluded from the finance charge. Fees paid to third-party mortgage brokers are also included in HOEPA’s trigger, even though when HOEPA was enacted in 1994 they were not automatically included in the finance charge. TILA was amended in 1995 to include all broker fees in the finance charge.

HOEPA's fee-based trigger. As a result, they caution that lenders choosing not to make HOEPA loans would be unable to offer single-premium credit insurance products to their loan customers. They assert that the financing of single-premium insurance provides protection to cash-poor consumers who are under-insured and, in some cases, offers less costly coverage compared with other forms of insurance. In short, these commenters generally support the current rule that does not include insurance premiums in the points and fees trigger. Alternatively, they recommend a rule that allows the insurance premiums to be excluded based on consumers' ability to cancel the coverage and obtain a full refund, where consumers are also provided with adequate information about their rights after the loan closing.

The staff believes that it is appropriate and consistent with the purposes of HOEPA to include premiums paid by consumers at closing for credit insurance (and other debt-protection products) in HOEPA's points and fee trigger. The coverage is purchased by the consumer in connection with the mortgage transaction, and the creditor or the credit account is the beneficiary. In addition, creditors receive commissions which may be significant for selling credit insurance (and retain the fee assessed for debt-cancellation coverage). This oftentimes represents a significant addition to the cost of the transaction to the borrower and an increase in benefit to the creditor. Moreover, when financed in connection with a subprime mortgage loan, as is typically the case, these charges can represent a significant addition to the loan balance, and thus, to the cost of the transaction and the size of the lien on the borrower's home.<sup>16</sup> HOEPA is specifically designed to help borrowers in high-cost mortgage transactions to understand the costs of the

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<sup>16</sup> Insurance industry commenters cited about \$.50 per \$100 of coverage, per year, as a typical cost of single-premium credit life insurance for one borrower. Policy terms of five to seven years are common for home-equity loans. The total cost of credit insurance in a particular mortgage transaction also depends on the number of borrowers covered, and whether disability and loss-of-income coverage are also purchased.

transaction and that borrowers may lose their home if they do not meet the full amount of their obligation under the loan.

In addition, anecdotal evidence has revealed that there are sometimes abuses associated with the sale and financing of single-premium credit insurance, which typically occur in subprime loans. Some consumers are not aware that they are purchasing the insurance, some may believe the insurance is required, and some may not understand that the term of insurance coverage may be shorter than the term of the loan. These abuses and misunderstandings can be addressed somewhat by applying HOEPA's protections and remedies, to the extent that including insurance in the points and fees test brings these loans under HOEPA. Moreover, including credit insurance premiums in HOEPA's fee-based trigger prevents unscrupulous creditors from evading HOEPA by packing a loan with such products in lieu of charging other fees that already are included under the current HOEPA trigger.

One likely effect of this adjustment to the trigger is that significantly more of the loans that include single-premium insurance will be covered by HOEPA's protections.<sup>17</sup> When there are abuses, such as coercive or deceptive sales practices, borrowers will benefit from HOEPA's rule requiring disclosures three days before closing. With the proposed HOEPA disclosure of the total loan amount, these consumers would receive advance notice about the additional amount they must borrow beyond their original loan request if they purchase the insurance. The draft final rule differs from the proposal in that the added disclosure specifies whether the loan amount includes the cost of optional insurance. Moreover, creditors and assignees will be subject to HOEPA's strict liability provisions and remedies when there are violations of law concerning the mortgage.

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<sup>17</sup> Data from the trade association indicate that assuming the APR trigger is lowered for first-lien mortgage loans, the incremental increase in HOEPA coverage due to the inclusion of credit insurance in the fee-based trigger would be 12 percent for first lien mortgages (covering 38 percent of first-lien mortgages) and 13 percent for subordinate-lien mortgages (covering 61 percent of subordinate-lien mortgages) covered by the survey.

As commenters noted, some creditors choose not to make loans covered by HOEPA, and if these creditors have been offering single-premium insurance, they may decide to cease doing so in order to remain outside of HOEPA's coverage. To the extent that some creditors choose not to offer single-premium policies, they can make credit insurance available through other vehicles such as policies that base monthly premiums on the outstanding loan balance.<sup>18</sup> Three large subprime mortgage lenders, including two leading firms, have already announced plans to offer credit insurance policies with monthly premiums and to discontinue single-premium policies.<sup>19</sup>

Disclosure alternatives — The Board solicited comment on whether optional credit insurance premiums should be excluded from the trigger when consumers have a right to cancel the policy, and disclosures about that right are provided after closing. Consumer representatives were opposed to the approach. Industry commenters supported the exclusion as a reasonable approach to address concerns about insurance packing.

The staff is not recommending this disclosure alternative, based on the belief that disclosure alone would be ineffective. A post-closing notice would likely be less effective than the HOEPA disclosures and remedies in deterring abusive lending practices in connection with insurance. Moreover, staff believes that reliance on consumers' exercise of their right to cancel the

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<sup>18</sup> Industry commenters assert that single-premium policies are less costly than monthly premium insurance and that single-premium insurance provides greater continuity of coverage because missing payments on the monthly-pay product may result in cancellation of insurance. Single-premium and monthly-premium policies have relative advantages and disadvantages. For example, a 5-year policy with a financed single-premium may result in smaller monthly payments because the cost is spread over the full loan term, which may be 10 or 20 years. But the consumer will also pay "points" and interest over the life of the loan on the additional amount financed for the coverage. Premiums assessed monthly, based on the outstanding loan balance, may result in a higher monthly expense, but they are not financed and would only be payable during the 5 years that coverage was in force, so the overall cost to the consumer could be lower.

<sup>19</sup> In July, Citigroup Inc. and Household International Inc., among other subprime lenders, announced decisions to discontinue the sale of single-premium credit insurance for mortgage loans. According to Inside B&C Lending, CitiFinancial and Household Financial were the top two B&C lenders in 2000, with a combined share of 24.3 percent of the total market.

insurance would not prevent abuses but would unfairly require vulnerable borrowers to take the initiative in remedying them.

## **2. Prohibit Certain Acts or Practices**

HOEPA authorizes the Board to prohibit acts or practices to curb abusive lending. The act provides that the Board shall prohibit practices: (1) in connection with all mortgage loans, if the Board finds the practice to be unfair, deceptive, or designed to evade HOEPA; and (2) in connection with refinancings of mortgage loans, if the Board finds that the practice is associated with abusive lending practices or otherwise not “in the interest of the borrower.”

Rule to address “loan flipping.” “Loan flipping” generally refers to the practice by brokers and creditors of frequently refinancing home-secured loans to generate additional fee income even though the refinancing is not in the borrower’s interest. Loan flipping is among the more flagrant of lending abuses. Victims tend to be borrowers who are having difficulty repaying a high-cost loan; they are targeted by brokers or creditors who promise to refinance the loan on more affordable terms. The refinancing typically provides little benefit to the borrower, as the loan amount increases mostly to cover fees. Often, there is minimal or no reduction in the interest rate. The monthly payment may increase, making the loan even more unaffordable. Sometimes the loan is amortized so that the monthly payment is reduced, but the loan may still be unaffordable. As long as there is sufficient equity to support the financing of additional fees, the consumer may be targeted repeatedly, resulting in equity stripping.

The proposed rule prohibited an originating creditor (or assignee) holding a HOEPA loan from refinancing that loan into another HOEPA loan within the first twelve months following origination, unless the new loan was “in the borrower’s interest.” Consumer representatives generally supported the proposal, but they believed the rule was too narrow and that all creditors and brokers should be covered. Creditors expressed concerns about the proposal’s coverage of

affiliates, and inquired whether an assignee merely servicing HOEPA loans is covered by the rule. Federal agencies, community groups, consumers and their representatives believe that the prohibition should be lengthened; suggestions ranged from 18 months to as long as four years.

Creditors' comments mainly focused on the "interest of the borrower" test. Both creditors and consumer representatives sought additional guidance in this area. Consumer representatives viewed the standard as too lenient, while creditors believed that the standard's lack of certainty would subject them to litigation risk.

The staff recommends adoption of a final rule that broadens the prohibition's coverage somewhat. Under the draft final rule, within the first twelve months of originating a HOEPA loan to a borrower, the creditor is prohibited from refinancing that loan (whether or not the creditor still holds the loan) or any other HOEPA loan held by that borrower into another HOEPA loan. Although a longer period might further limit the opportunity for loan flipping, the staff believes that one year provides an appropriate balance between the need to address the clearest cases of abusive refinancings and the need not to restrict the free flow of credit in legitimate transactions. Assignees would be under the same restrictions as the original creditor while holding or servicing the loan.<sup>20</sup>

The proposal was narrowly tailored to curb the more egregious cases of loan flipping: repeated refinancing by creditors that hold HOEPA loans in portfolio. The proposed rule did not cover loan originators that close loans in their own name and immediately assign the loans to the funding party or sell them in the secondary market. Once a creditor assigned the loan, the assignee would have been covered, but the originating creditor could have refinanced the HOEPA loan.

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<sup>20</sup> Assignees are covered by the rule because in some instances they are the "true creditor" funding the loan. Even when they are not acting as creditors, assignees are subject to the refinancing restrictions to ensure that loans are not transferred for the purpose of evading the prohibition, and to ensure that borrowers are not pressured into frequent refinancings by the party holding to servicing the loan.

The hearing testimony and comments suggest that some of these originators are the source of unaffordable loans because they do not have a vested interest in the borrower's ability to repay the loan. The final rule has been expanded to cover creditors (including brokers) that originate HOEPA loans, whether or not they continue to hold the loan. The rule has been revised to clarify that it applies to assignees that service a HOEPA loan, as well as assignees that purchase it.

Under the proposal, the general prohibition applied to creditors' affiliates. Based on the comments, the application of the rule to creditors' affiliates has been narrowed; loans made by the affiliate would violate HOEPA only if the creditor engages in a pattern or practice of arranging loans with its affiliate to evade the flipping prohibition.

Additional guidance is provided on lenders' ability to make loans that are in the borrower's interest notwithstanding the loan-flipping prohibition. The proposal indicated that this must be determined by the totality of circumstances in specific cases and, as an example, stated that one factor to consider is the amount of any new funds advanced in comparison with the total loan charges for the refinancing. Under the draft final rule, a refinancing is in the borrower's interest if the loan is needed for a "bona fide personal financial emergency." The standard of a bona fide personal financial emergency is the current standard for certain consumer waivers under TILA.<sup>21</sup> Whether a loan is in the borrower's interest is to be determined in each case based on the actual circumstances; consequently, a mere statement by a borrower that "this loan is in my interest" would not meet the standard.

Commenters offered many suggestions for more specific guidance on examples of "borrower's interest," such as lowering the rate or the monthly payment, or eliminating a balloon

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<sup>21</sup> TILA authorizes the Board to permit consumers to waive the three-day rescission period for certain home equity loans or the three-day waiting period before closing a HOEPA loan, if necessary for homeowners to meet a bona fide personal financial emergency. The staff commentary provides that the imminent sale of the consumer's home at foreclosure during the three-day HOEPA waiting period is an example of a bona fide personal financial emergency.

payment or variable rate feature. Although a list of acceptable loan purposes would provide more certainty, it is difficult to identify circumstances that would unequivocally be in the borrower's interest in all or even most cases. A good reason in one context may be abusive in other circumstances. For example, a homeowner's equity could still be stripped through repeated refinancings that carry high up-front fees even if they result in incrementally lower APRs.

In recommending that the "borrower's interest" exception be retained, the staff believes that precisely defining circumstances that are "in the borrower's interest" is not necessary, given the nature of the loan flipping prohibition. The prohibition applies for a relatively short period, and is intended as a strong deterrent for the more egregious cases. The "borrower's interest" exception must be narrowly construed to preserve the effectiveness of the overall prohibition. Moreover, the probability that creditors in legitimate transactions would refinance their own HOEPA loans within twelve months is typically low.

The staff recognizes that this approach places the primary burden on the creditor, in light of the totality of the circumstances, to weigh whether the loan is in the borrower's interest. The standard, however, gives creditors in legitimate transactions some flexibility for extenuating circumstances, while creditors that rely on the exception routinely to "flip" HOEPA loans bear the risk that a court will find that they violated HOEPA.

Limitations on refinancing low-rate loans. The December proposal addressed abuses involving the refinancing of low-rate loans originated through mortgage assistance programs designed to give low- or moderate-income borrowers the opportunity for homeownership.<sup>22</sup> Under the proposal creditors would be prohibited, in the first five years of a zero interest rate or other

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<sup>22</sup> Some of these homeowners who have unsecured debts have been targeted by unscrupulous lenders who consolidate the debts and replace the low-cost, first-lien mortgage with a substantially higher cost loan. The replacement loans are often unaffordable, many involve "loan flipping" and, as a result, homeowners have lost their homes. In some cases, the low-cost loan is replaced even though the first-lien holder may be willing to subordinate its security interest.

low-rate loan, from replacing that loan with any higher-rate loan unless the refinancing is in the interest of the borrower. Based on the comments received and after consultation with the Consumer Advisory Council and further analysis, the staff is not recommending that the Board adopt the proposed rule.

Unlike the prohibition against loan flipping, which applies only to HOEPA creditors, the low-cost loan prohibition as proposed would have applied to all mortgage refinancing creditors. While borrowers with low-cost mortgage loans could benefit from the rule, the benefits appear to be far outweighed by the potential compliance burden for all home-equity lenders. The preamble to the draft final rule indicates that the rule is being withdrawn and that if problems persist, the Board could consider in a future rulemaking approaches that provide appropriate protections for such borrowers without imposing undue burden for creditors.

“Spurious” open-end credit. HOEPA covers only closed-end loans. The staff recommends adoption of an explicit prohibition, as proposed, against treating a mortgage loan as an open-end credit line to evade HOEPA’s requirements if the loan does not meet the TILA definition of open-end credit. For example, a high-cost mortgage could not be structured as a home-secured line of credit if the consumer did not apply for such a line and there is no reasonable expectation that repeat transactions will occur under a reusable line of credit. Although the practice would currently violate TILA, the new rule would subject creditors and assignees to HOEPA’s stricter liability rule and remedies if the credit carries rates and fees that exceed HOEPA’s price triggers for closed-end loans. This prohibition responds to actual cases reported by the Federal Trade Commission and consumer advocates.

“Due-on-demand” clauses. As proposed, the staff recommends prohibiting the use of “due-on-demand” or “call” provisions in HOEPA loans, unless the clause is exercised in connection with a consumer’s default. Most commenters supported the proposal. Some industry commenters

asked the Board to limit the prohibition to HOEPA loans with terms of less than five years, consistent with HOEPA's ban on balloon payments. HOEPA prohibits short-term balloon notes to prevent creditors from forcing consumers to refinance their loans and pay additional points and fees. Although "due-on-demand" and "call" provisions currently do not appear to be widely used in HOEPA loans, a creditor could, potentially, force the consumer to refinance by reserving the right to call the loan at any time and demand payment of the entire outstanding balance.

Prohibiting the use of call provisions in HOEPA loans is intended to ensure that lenders do not accelerate the payment of these loans, without cause, at any time during the loan term.

Loans covered by HOEPA are more likely to involve borrowers who have less-than-perfect credit histories, who might not be served by prime lenders. Because these consumers either have or perceive they have fewer options than other borrowers, they may be more vulnerable to unscrupulous lenders or brokers. Accordingly, HOEPA includes limitations on certain loan provisions to protect these borrowers from onerous loan terms. The staff believes that it would also be appropriate to protect HOEPA borrowers from the potentially harsh effect of allowing a creditor to exercise a "due-on-demand" clause at any time, unless there is legitimate cause.

The hearing testimony and comments received by the Board did not identify any benefits to using due-on-demand clauses in HOEPA loans, other than in the legitimate cases that are permitted under the Board's rule. The rule allows creditors to exercise such clauses when the creditor is faced with borrower misrepresentations or fraud, the borrower fails to meet repayment terms, or a borrower's action (or failure to act) affects the creditor's security for the loan. For example, the rule would not affect creditors' use of "due-on-sale" clauses.

The limitations on due-on-demand clauses adopted by the Board for HOEPA loans are similar to TILA's existing limits on the use of such clauses for home-equity lines of credit (HELOCs), where the Congress recognized that allowing creditors to unilaterally terminate a

home-equity line (or significantly change loan terms) was fundamentally unfair when the consumer's home was at stake. The staff recommends that the Board make a finding that allowing creditors' unlimited discretion to call the loan and require immediate repayment is similarly unfair with HOEPA loans.

### **3. Strengthen HOEPA's Prohibition on Loans Based on Homeowners' Equity Without Regard to Repayment Ability**

Under HOEPA, a creditor may not engage in a pattern or practice of making HOEPA loans based on the equity in the borrower's home without regard to the borrower's repayment ability, taking into account the consumer's current and expected income, current obligations, and employment status.<sup>23</sup> Currently, compliance with the statutory prohibition is difficult to enforce because creditors are not required to document that they considered the consumer's ability to repay.

The staff recommends that, for HOEPA loans, creditors generally be required to verify and document consumers' current or expected income, current obligations, and employment to the extent applicable, as proposed. If a creditor engages in a pattern or practice of making HOEPA loans without verifying and documenting consumers' repayment ability, there would be a presumption that the creditor has violated the rule against making loans based solely on equity. A creditor may rely on any reliable source that provides the creditor with a reasonable basis for believing that, given the verified income and obligations, there are sufficient funds to support the loan. In response to requests from commenters on the issue, guidance would clarify that

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<sup>23</sup> The Board proposed to clarify the "pattern or practice" requirement by stating that creditors could generally look to the interpretations of "pattern or practice" under other remedial statutes, such as the Fair Housing Act, the Equal Credit Opportunity Act, the Truth in Lending Act, and the Equal Employment Opportunity Act. The commenters generally requested more specific guidance. As revised, the staff commentary would distill the interpretations issued under these other laws by noting that while a "pattern or practice" of violations is not established by isolated, random, or accidental acts, it can be established without using a statistical process. The final interpretation also notes that a creditor might act under a lending policy and that action alone could establish that there is a pattern or practice of violating the prohibition against unaffordable lending.

verification contemplates the use of independent sources to confirm information and that documentation contemplates memorializing and retaining the information used by the creditor to make the credit decision.

#### **4. Enhance HOEPA Disclosures Provided Before Closing**

Currently, creditors offering HOEPA loans must provide abbreviated disclosures to consumers at least three business days before the loan is closed, in addition to the disclosures generally required by TILA at or before closing. The HOEPA disclosures inform consumers that they are not obligated to complete the transaction and could lose their home if they obtain the loan and fail to make payments. It also includes a few items about cost, such as the APR and the monthly payment (including the maximum payment for variable-rate loans and any balloon payment).

Amount borrowed. The staff recommends that the face amount of the note (“amount borrowed”) be added to the current HOEPA disclosure for refinancings, as proposed.<sup>24</sup> Adding the face amount of the note would alert consumers well in advance of the loan closing that the total amount borrowed may be substantially higher than the amount requested due to the financing of points, fees, and insurance.<sup>25</sup> Creditors and consumer representatives generally supported the proposal, although some questioned the effectiveness of requiring additional HOEPA disclosures as a means to prevent predatory lending. The “amount borrowed” disclosure is enhanced in the final rule to specify whether the loan amount includes premiums for optional credit insurance, to

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<sup>24</sup> Under Section 129(1)(2)(B) of TILA, the Board is authorized to require additional disclosures, but only for refinancings, if the Board finds the disclosures to be in the interest of borrowers. Some HOEPA loans that are secured by subordinate liens would not be covered by the rule.

<sup>25</sup> In a 1999 report to Congress, the Board recommended that Congress amend TILA’s disclosure requirements generally to include the total loan amount rather than the “amount financed” which excludes from the loan amount any prepaid finance charges.

address insurance “packing” where consumers may not be aware that insurance coverage has been added to their loan balance or it is optional.

In response to comments on the issue, the staff also recommends providing a small tolerance to the new disclosure. The disclosed amount borrowed (and the payment amount affected by the disclosed amount) would be deemed accurate if the disclosed amount varied no more than \$100 from the actual amount borrowed. This approach provides some flexibility for creditors and produces minimal variances to monthly payment amounts.

**FEDERAL RESERVE SYSTEM****12 CFR Part 226****[Regulation Z; Docket No. R-1090]****Truth in Lending**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Final rule.

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**SUMMARY:** The Board is adopting amendments to the provisions of Regulation Z (Truth in Lending) that implement the Home Ownership and Equity Protection Act (HOEPA). HOEPA was enacted in 1994, in response to evidence of abusive lending practices in the home-equity lending market. HOEPA imposes additional disclosure requirements and substantive limitations (for example, restricting short-term balloon notes) on home-equity loans bearing rates or fees above a certain percentage or amount. The Board's amendments to Regulation Z broaden the scope of mortgage loans subject to HOEPA by adjusting the price triggers used to determine coverage under the act. The rate-based trigger is lowered by two percentage points for first-lien mortgage loans, with no change for subordinate-lien loans. The fee-based trigger is revised to include the cost of optional credit insurance and similar debt protection products paid at closing. The amendments restrict certain acts and practices in connection with home-secured loans. For example, creditors may not engage in repeated refinancings of their HOEPA loans over a short time period when the transactions are not in the borrower's interest. The amendments also strengthen HOEPA's prohibition against extending credit without regard to consumers' repayment ability, and enhance disclosures received by consumers before closing for HOEPA-covered loans.

**DATES:** The rule is effective [Insert date of publication in the Federal Register]; compliance is mandatory as of October 1, 2002.

**FOR FURTHER INFORMATION CONTACT:** Minh-Duc T. Le, Attorney, Daniel G.

Lonergan, Counsel, or Jane E. Ahrens, Senior Counsel, Division of Consumer and Community Affairs, at (202) 452-3667 or 452-2412; for users of Telecommunications Device for the Deaf (“TDD”) only, contact (202) 263-4869.

**SUPPLEMENTARY INFORMATION:**

**I. Background**

Since the mid-1990s, the subprime mortgage market has grown substantially, providing access to credit to borrowers with less-than-perfect credit histories and to other borrowers who are not served by prime lenders. With this increase in subprime lending there has also been an increase in reports of “predatory lending.” The term “predatory lending” encompasses a variety of practices. In general, the term is used to refer to abusive lending practices involving fraud, deception, or unfairness. Some abusive practices are clearly unlawful, but others involve loan terms that are legitimate in many instances and abusive in others, and thus are difficult to regulate. Loan terms that may benefit some borrowers, such as balloon payments, may harm other borrowers, particularly if they are not fully aware of the consequences. The reports of predatory lending have generally included one or more of the following: (1) making unaffordable loans based on the borrower’s home equity without regard to the borrower’s ability to repay the obligation; (2) inducing a borrower to refinance a loan repeatedly, even though the refinancing may not be in the borrower’s interest, and charging high points and fees each time the loan is refinanced, which decreases the consumer’s equity in the home; and (3) engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower—for example, “packing” loans with credit insurance without a consumer’s consent.

### **A. The Home Ownership and Equity Protection Act**

In response to anecdotal evidence about abusive practices involving home-secured loans with high rates or high fees, in 1994 the Congress enacted the Home Ownership and Equity Protection Act (HOEPA), Pub. L. 103-325, 108 Stat. 2160, as an amendment to the Truth in Lending Act (TILA), 15 U.S.C. 1601 *et seq.* TILA is intended to promote the informed use of consumer credit by requiring disclosures about its terms and cost. TILA requires creditors to disclose the cost of credit as a dollar amount (the “finance charge”) and as an annual percentage rate (the “APR”). Uniformity in creditors’ disclosures is intended to assist consumers in comparison shopping. TILA requires additional disclosures for loans secured by a consumer’s home and permits consumers to rescind certain transactions that involve their principal dwelling. TILA is implemented by the Board’s Regulation Z, 12 CFR part 226.

HOEPA identifies a class of high-cost mortgage loans through rate and fee triggers, and it provides consumers entering into these transactions with special protections. HOEPA applies to closed-end home-equity loans (excluding home-purchase loans) bearing rates or fees above a specified percentage or amount. A loan is covered by HOEPA if (1) the APR exceeds the rate for Treasury securities with a comparable maturity by more than 10 percentage points, or (2) the points and fees paid by the consumer exceed the greater of 8 percent of the loan amount or \$400. The \$400 figure set in 1994 is adjusted annually based on the Consumer Price Index. The dollar figure for 2001 is \$465 and for 2002 is \$480. 66 FR 57849, November 19, 2001.

HOEPA is implemented in § 226.32 of the Board’s Regulation Z. HOEPA also amended TILA to require additional disclosures for reverse mortgages that are contained in § 226.33 of Regulation Z. For purposes of this notice of rulemaking, however, the term “HOEPA-covered loan” or “HOEPA loan” refers only to mortgages covered by § 226.32 that meet HOEPA’s rate or fee-based triggers.

Creditors offering HOEPA-covered loans must give consumers an abbreviated disclosure statement at least three business days before the loan is closed, in addition to the disclosures generally required by TILA before or at closing. The HOEPA disclosure informs consumers that they are not obligated to complete the transaction and could lose their home if they take the loan and fail to make payments. It includes a few key items of cost information, including the APR. In loans where consumers have three business days after closing to rescind the loan, the HOEPA disclosure thus affords consumers a minimum of six business days to consider accepting key loan terms before receiving the loan proceeds.

HOEPA restricts certain loan terms for high-cost loans because they are associated with abusive lending practices. These terms include short-term balloon notes, prepayment penalties, non-amortizing payment schedules, and higher interest rates upon default. Creditors are prohibited from engaging in a pattern or practice of making HOEPA loans based on the homeowner's equity without regard to the borrower's ability to repay the loan. Under HOEPA, assignees are generally subject to all claims and defenses with respect to a HOEPA loan that a consumer could assert against the creditor. HOEPA also authorizes the Board to prohibit acts or practices in connection with mortgage lending under defined criteria.

#### **B. Continued Concerns About Predatory Lending Practices**

Since the enactment of HOEPA in 1994, the volume of home-equity lending has increased significantly in the subprime mortgage market. Based on data reported under the Home Mortgage Disclosure Act (HMDA), 12 U.S.C. 2801 *et seq.*, the number of nonpurchase-money loans made by lenders that are identified as engaging in subprime lending increased about five-fold—from 138,000 in 1994 to roughly 658,000 in 2000. While such lending benefits consumers by making credit available, it also raises concerns that the increase in the number of subprime loans brings a corresponding increase in the number of predatory loans.

In the past two years, various initiatives to address predatory lending have been undertaken. The Senate Banking Committee held hearings in July 2001 at which consumers and representatives of industry and consumer groups testified; the House Banking Committee held hearings in May 2000 at which the banking regulators and others testified; and bills have been introduced to address predatory lending. Several states and municipalities have enacted or are considering legislation or regulations. The Department of Housing and Urban Development and the Department of Treasury held a number of public forums on predatory lending and issued a report in June 2000. The report makes recommendations to the Congress regarding legislative action and to the Board urging the use of its regulatory authority to address predatory lending practices. Fannie Mae and Freddie Mac published guidelines last year to avoid purchasing loans that are potentially predatory; they are also making efforts to develop consumers' awareness of their credit options.

The Board has conferred with its Consumer Advisory Council and Board staff have met with other industry representatives and consumer advocates on the issue of predatory lending. In 2000, the Board held hearings in Charlotte, Boston, Chicago, and San Francisco, to consider approaches the Board might take in exercising its regulatory authority under HOEPA. The Board's hearings focused on expanding the scope of mortgage loans covered by HOEPA, prohibiting specific acts or practices, improving consumer disclosures, and educating consumers. Transcripts of the hearings can be accessed on the Board's Internet web site at <http://www.federalreserve.gov/community.htm>. In the notices announcing the hearings, the Board also solicited written comment on possible revisions to Regulation Z's HOEPA rules. 65 FR 45547, July 24, 2000. The Board received approximately 450 comment letters in response to the notices, two-thirds of which were from consumers generally encouraging Board action to curb predatory lending.

### **C. The Board's Proposed Rule to Amend Regulation Z**

The Board published a proposed rule to amend Regulation Z in December 2000. 65 FR 81438, December 26, 2000. The Board proposed to broaden the scope of mortgage loans subject to HOEPA by adjusting the price triggers used to determine coverage under the act; to prohibit certain acts and practices in connection with home-secured loans covered by HOEPA; to require increased scrutiny on creditors' practices to document and verify income; and to enhance disclosures received by consumers before closing for HOEPA-covered loans.

The Board received approximately 200 letters that specifically addressed the proposed revisions and represented the views of the mortgage lending industry, credit insurance industry, consumer and community development groups, and government agencies. In addition, the Board received approximately 1,100 identical e-mail comment letters from consumers generally encouraging the Board to curb predatory lending.

Most of the creditors and other commenters involved in mortgage lending opposed making more loans subject to HOEPA. They believe that the coverage of more loans would reduce competition and the availability of credit in the range of rates affected because some lenders, as a matter of policy, will not make HOEPA loans. With regard to the new rules that would apply to HOEPA loans, creditors wanted more flexibility and compliance guidance. Consumer representatives and community development organizations generally supported the proposal as a step forward in addressing the problem of predatory lending but believed additional steps are needed to ensure consumers are protected.

### **II. Summary of Final Rule**

With some exceptions, the Board is adopting the revisions substantially as proposed to address predatory lending and unfair practices in the home-equity market. The revisions are adopted pursuant to the Board's authority to adjust the APR trigger and add additional charges to

the points and fees trigger. See 15 U.S.C. 1602(aa). Revisions are also issued pursuant to the Board's authority under HOEPA to prohibit certain acts or practices (1) affecting mortgage loans if the Board finds the act or practice to be unfair, deceptive, or designed to evade HOEPA, or (2) affecting refinancings if the Board finds the act or practice to be associated with abusive lending or otherwise not in the interest of the borrower. 15 U.S.C. 1639(1)(2). Revisions are also adopted pursuant to section 105(a) of TILA to effectuate the purposes of TILA, to prevent circumvention or evasion, or to facilitate compliance. 15 U.S.C. 1604(a).

The amendments (1) extend the scope of mortgage loans subject to HOEPA's protections, (2) restrict certain acts or practices, (3) strengthen HOEPA's prohibition on loans based on homeowners' equity without regard to repayment ability, and (4) enhance HOEPA disclosures received by consumers before closing, as follows.

The final rule adjusts the APR trigger for first-lien mortgage loans, from 10 percentage points to 8 percentage points above the rate for Treasury securities having a comparable maturity, the maximum amount that the Board may lower the trigger. The APR trigger for subordinate-lien loans remains at 10 percentage points. The fee-based trigger is adjusted to include amounts paid at closing for optional credit life, accident, health, or loss-of-income insurance, and other debt-protection products.

The final rule also addresses some "loan flipping" within the first year of a HOEPA loan. Except in limited circumstances, a creditor that has made a HOEPA loan to a borrower is generally prohibited for twelve months from refinancing any HOEPA loan made to that borrower into another HOEPA loan. Assignees holding or servicing a HOEPA loan are subject to similar restrictions.

To prevent the evasion of HOEPA, which only covers closed-end loans, the final rule prohibits a creditor from wrongfully documenting such loans as open-end credit. For example, a

high-cost mortgage may not be structured as a home-secured line of credit if there is no reasonable expectation that repeat transactions will occur under a reusable line of credit. To ensure that lenders do not accelerate the payment of HOEPA loans without cause, the final rule prohibits a creditor from exercising “due-on-demand” or call provisions in a HOEPA loan, unless the clause is exercised in connection with a consumer’s default. A similar rule applies to home-secured lines of credit under Regulation Z.

The final rule seeks to strengthen HOEPA’s prohibition on making loans based on homeowners’ equity without regard to repayment ability. It creates a presumption that a creditor has violated the statutory prohibition on engaging in a pattern or practice of making HOEPA loans without regard to repayment ability if the creditor generally does not verify and document consumers’ repayment ability.

The final rule revises the HOEPA disclosures (given three days before loan closing) for refinancings, to alert consumers to the total amount borrowed, which may be substantially higher than the loan amount requested due to the financing of credit insurance, points, and fees. To enhance consumer awareness, and deter insurance packing, the HOEPA disclosure must specify whether the total amount borrowed includes the cost of optional insurance.

The staff commentary to Regulation Z has also been revised to provide guidance on the new rules and to clarify existing requirements. Revisions to the regulation and the staff commentary are discussed in detail below in the section-by-section analysis.

### **III. Section-by-Section Analysis of Final Rule**

#### **Subpart A — General**

##### **Section 226.1 — Authority, Purpose, Coverage, Organization, Enforcement and Liability**

Section 226.1(b) on the purpose of the regulation is revised as proposed to reflect the addition of prohibited acts and practices in connection with credit secured by a consumer’s

dwelling. Section 226.1(d) on the organization of the regulation is revised to reflect the restructuring of Subpart E (rules for certain home mortgage transactions).

### **Subpart C — Closed-end Credit**

#### **Section 226.23 — Right of Rescission**

##### 23(a) Consumer's Right to Rescind

The proposed amendment to footnote 48 to § 226.23(a)(3) is unnecessary given the organization of the final rule, and thus has not been adopted.

### **Subpart E — Special Rules for Certain Home Mortgage Transactions**

#### **Section 226.31 □ General Rules**

##### 31(c) Timing of Disclosure

##### 31(c)(1)(i) Change in Terms

Section 226.31(c)(1) requires a three-day waiting period between the time the consumer is furnished with disclosures required under § 226.32 and the time the consumer becomes obligated under the loan. If the creditor changes any terms that make the disclosures inaccurate, new disclosures must be given and another three-day waiting period is triggered.

Comment § 226.31(c)(1)(i)-2 is added, as proposed, to clarify redisclosure requirements when, after a consumer receives a HOEPA disclosure and before consummation, loan terms change that make the disclosure inaccurate. The Board's 2000 hearings revealed that some creditors offer credit insurance and other optional products at loan closing. If the consumer finances the purchase of such products and as a result the monthly payment differs from what was previously disclosed under § 226.32, the terms of the extension of credit have changed; redisclosure is required and a new three-day waiting period applies. See discussion below concerning § 226.32(c)(3) on when optional items may be included in the regular payment disclosure.

**Section 226.32 — Requirements for Certain Closed-end Home Mortgages**32(a) Coverage

HOEPA disclosures and restrictions cover home-equity loans that meet one of the act's two "high-cost" triggers—a rate trigger and a points and fees trigger. Under the final rule, both triggers are revised to cover more loans.

APR trigger — Currently, a loan is covered by HOEPA if the APR exceeds by more than 10 percentage points the rate for Treasury securities with a comparable maturity. Section 103(aa) of TILA authorizes the Board to adjust the APR trigger by 2 percentage points from the current standard of 10 percentage points upon a determination that the increase or decrease is consistent with the consumer protections against abusive lending contained in HOEPA and is warranted by the need for credit.

The Board had proposed to reduce the rate trigger from 10 to 8 percentage points above the rate for Treasury securities with a comparable term for all loans, the maximum adjustment that the Board can make. With this change, based on recent rates for Treasury securities, home-equity loans with a term of 10 years would be subject to HOEPA if they have an APR of approximately 13 percent or higher.

The Board solicited comment on an alternative approach that would differentiate between first- and subordinate-lien loans in the application of the APR trigger. Under the two-tiered alternative, the APR trigger for first-lien mortgages would be reduced to 8 percentage points; the APR trigger for subordinate-lien loans would remain at 10 percentage points. The final rule adopts the two-tiered alternative approach.

HOEPA provides that the Board may adjust the APR trigger after consulting with representatives of consumers and lenders and determining that the increase or decrease is consistent with the purpose of consumer protection in HOEPA and is warranted by the need for

credit. (The Board may not adjust the trigger more frequently than once every two years.)

Consistent with this mandate, the Board has held public hearings, considered the testimony at other hearings held by government agencies and the Congress, analyzed comment letters, held discussions with community groups and lenders, consulted its Consumer Advisory Council, and reviewed data from various studies and reports on the home-equity lending market.

Most of the information the Board received about predatory lending is anecdotal, as it was when Congress passed HOEPA in 1994. The reports of actual cases (including additional Congressional testimony by consumers) are, however, widespread enough to indicate that the problem warrants addressing. Homeowners in certain communities—frequently the elderly, minorities, and women—continue to be targeted with offers of high-cost, home-secured credit with onerous loan terms. The loans, which are typically offered by nondepository institutions, carry high up-front fees and may be based solely on the equity in the consumers' homes without regard to their ability to make the scheduled payments. When homeowners have trouble repaying the debt, they are often pressured into refinancing their loans into new unaffordable, high-fee loans that rarely provide economic benefit to the consumers. These refinancings may occur frequently. The loan balances increase primarily due to fees that are financed resulting in reductions in the consumers' equity in their homes and, in some cases, foreclosure may occur. The loan transactions also may involve fraud and other deceptive practices.

Creditors have expressed concern that lowering the HOEPA rate trigger would adversely affect credit availability for loans in the range of rates that would be covered by the lowered trigger. Many creditors, ranging from community banks to national lenders, have stated that they do not offer HOEPA loans due to their concerns about compliance burdens, potential liability, reputational risk, and difficulty in selling these loans to the secondary market. Some creditors

believe there are insufficient data about the incidence of predatory lending occurring in loans immediately below the existing HOEPA triggers to support lowering the trigger.

Anecdotal evidence suggests that subprime borrowers with rates below the current HOEPA triggers also have been subject to abusive lending practices. There are no precise data, however, on the number of subprime loans in the market as a whole that would be affected by lowering the HOEPA rate trigger. The precise effect that lowering the APR trigger will have on creditors' business strategies is difficult to predict. It seems likely that lenders that already make HOEPA loans and have compliance systems in place would continue making them under a revised APR trigger. Some creditors that choose not to make HOEPA loans may refrain from making loans in the range of rates that would be covered by the lowered threshold. But other creditors may fill any void left by creditors that do not make HOEPA loans, either because they already make HOEPA loans or because they are willing to do so in the future. And others may have the flexibility to avoid HOEPA's coverage by lowering rates or fees for some loans at the margins, consistent with the risk involved. Data submitted by a trade association representing nondepository institution lenders suggest that there is an active market for HOEPA loans under the current APR trigger. There is no evidence that the impact on credit availability will be significant if the trigger is lowered. Accordingly, the Board believes that lowering the APR trigger to expand HOEPA's protections to more loans is consistent with consumers' need for credit, and therefore, warranted.

Moreover, lowering the rate trigger seeks to ensure that the need for credit by subprime borrowers will be fulfilled more often by loans that are subject to HOEPA's protections. Borrowers who have less-than-perfect credit histories and those who might not be served by prime lenders have benefited from the substantial growth in the subprime market. But a borrower does not benefit from expanded access to credit if the credit is offered on unfair terms, the repayment costs are unaffordable, or the loan involves predatory practices. Because consumers who obtain

subprime mortgage loans have, or perceive they have, fewer options than other borrowers, they may be more vulnerable to unscrupulous lenders or brokers.

The Board has also determined that lowering the rate trigger is consistent with the consumer protections against abusive lending provided by HOEPA. The Act's purpose is to protect the most vulnerable consumers, based on the cost of the loans, from abusive lending practices. As noted above, anecdotal evidence suggests that subprime borrowers with loans priced below HOEPA's current APR trigger have been subject to predatory practices, such as unaffordable lending, loan flipping and insurance packing. These are the very types of abuses that HOEPA was intended to prevent. With a lowered trigger, more consumers with high-cost loans will receive cost disclosures three days before closing (instead of at closing) and will be protected by HOEPA's prohibitions against onerous loan terms, such as non-amortizing payment schedules, balloon payments on short-term loans, or interest rates that increase upon default. A wider range of high-cost loans will also be subject to HOEPA's rule against unaffordable lending, and to HOEPA's restrictions on prepayment penalties. The rules being adopted by the Board to address loan flipping will also apply to more loans. Lastly, more high-cost loans will be subject to the HOEPA rule that holds loan purchasers and other assignees liable for any violation of law by the original creditor with respect to the mortgage.

Two-tiered approach — Of the 200 commenters on the proposal, about 40 discussed the two-tiered trigger approach and were about evenly divided. Creditors and some consumer groups favored the two-tiered trigger approach. Those opposed included community groups, some creditors, and others that generally believe that there should be no distinction drawn between first-lien and subordinate-lien loans. Community groups believe that the maximum number of subprime mortgage loans should be subject to HOEPA's protections. Many suggested that the two-tiered approach could be helpful if both triggers were substantially lower than what the Board

is authorized to adopt. Some creditors that opposed the tiered-approach believe that the Board should not issue a rule that might encourage the making of loans that would place creditors in a subordinate lien position. One institution noted that a subordinate-lien loan may not be more favorable to a consumer if it results in a combined monthly payment on the first and second mortgages that is higher than the monthly payment on a consolidated first-lien mortgage loan. Some commenters believe that borrowers with subordinate-lien loans face similar risks of abusive practices as with first-lien loans. A few stated that the tiered approach would add unnecessary complexity to both compliance and enforcement efforts.

Data are not available on the number of home-equity loans currently subject to HOEPA, or the number of loans that would be covered if the APR trigger were lowered. At the time of the proposal, data from the Mortgage Information Corporation (MIC) compiled by the Office of Thrift Supervision suggested that lowering the APR trigger by 2 percentage points could expand HOEPA's coverage from approximately 1 percent to 5 percent of subprime mortgage loans. Further analysis of additional MIC data suggests that these percentages of coverage may be typical of longer-term, first-lien mortgages, and that the coverage percentages are higher for shorter-term and subordinate-lien loans.

In response to the Board's request in the proposal, a few commenters provided data on the number of loans they offered in recent years that would have been affected by a rate trigger of 8 percentage points above a comparable Treasury security. The most extensive data were submitted by a trade association representing nondepository institution lenders. The association collected data from the subprime lending divisions of nine member institutions. The number of loans surveyed is about 36 percent of the number of loans of subprime lenders recorded under HMDA during the survey period (mid-year 1995 through mid-year 2000). The dollar volume for the loans surveyed is about 20 percent of the dollar volume of loans reported by subprime lenders under

HMDA. Overall, the trade association data show that for these loans, HOEPA's existing APR trigger would have covered about 9 percent of the first-lien loans, and that lowering the APR trigger by 2 percentage points would have resulted in coverage of nearly 26 percent of the first-lien loans surveyed. For subordinate-lien loans, about 47 percent of the surveyed loans would have been covered by HOEPA's APR trigger, and the data suggest that lowering the APR trigger by 2 percentage points would have resulted in coverage of about 75 percent of the subordinate-lien loans.

Most of the evidence of predatory lending brought to the Board's attention to date has involved abuses in connection with first-lien mortgage loans. When a consumer seeks a loan to consolidate debts or finance home repairs, some creditors require consumers to borrow additional funds to pay off the existing first mortgage as a condition of providing the loan, even though the existing first mortgage may have been at a lower rate. This ensures that the creditor will be the senior lien-holder, but it also results in an increase, perhaps significant, in the points and fees paid for the new loan (since the latter are calculated on a much larger loan amount).

The Board's final rule lowers the APR trigger for first lien-mortgages only. Subordinate-lien loans are already covered more frequently by HOEPA because the rates on these loans are higher than first-lien loans. The data suggests that coverage under the current triggers could be significant for subordinate-lien loans. Moreover, the evidence of abusive practices has pertained primarily to first lien mortgages. Based on these factors, the Board is adjusting the APR trigger only for first-lien loans, but retains the ability to lower the trigger for subordinate-lien loans at a future date.

### 32(b) Definition

Points and fees trigger — Currently, home-equity loans are subject to HOEPA if the points and fees payable by the consumer at or before loan closing exceed the greater of 8 percent of the

total loan amount or \$465. (The dollar trigger is \$480 for 2002; 66 FR 57849, November 19, 2001.) “Points and fees” include all finance charges except for interest. The trigger also includes some fees that are not finance charges, such as closing costs paid to the lender or an affiliated third party. HOEPA authorizes the Board to add “such other charges” to the points and fees trigger as the Board deems appropriate.

The comment letters and testimony at the hearings raised a number of concerns about single-premium credit insurance, such as excessive costs, high-pressure sales tactics, consumers’ confusion as to the voluntariness of the product, and “insurance packing.” The term “packing” in this case refers to the practice of automatically including optional insurance in the loan amount without the consumer’s request; as a result, some consumers may perceive that the insurance is a required part of the loan, and others may not be aware that insurance has been included.

In response to the reported abuses, the Board proposed to include in the fee trigger premiums paid at closing for optional credit life, accident, health, or loss-of-income insurance and other debt-protection products; such premiums are typically financed. Premiums paid for required credit insurance policies are considered finance charges and are already included in the points and fees trigger.

Many commenters expressed views on this issue. The views were sharply divided. In general, consumer representatives, some federal agencies, state law enforcement officials, and some others supported the inclusion of optional credit insurance premiums in HOEPA’s points and fees trigger, although they would have preferred an outright ban on the purchase or financing of single-premium products. Consumer representatives were generally concerned about the cost of the insurance, its voluntariness, and its contribution to equity stripping. They believe that borrowers are often unaware that insurance has been included in their loan balance or that borrowers perceive that the insurance is required. They also note that these problems exist

notwithstanding the fact that TILA currently requires creditors to disclose before consummation that the insurance is optional in order to exclude it from the HOEPA fee trigger. (If creditors fail to disclose that the insurance is optional, TILA requires that the cost be treated as a finance charge, and all finance charges are in the current HOEPA fee trigger.) They state that excessively high premiums contribute to the problem of equity stripping. They also note that consumers pay interest on the financed premium for the entire loan term even though insurance coverage typically expires much earlier.

Most creditors and commenters representing the credit insurance industry strongly opposed the inclusion of optional insurance premiums paid at closing in the points and fees trigger. Some creditors questioned the Board's use of its authority under HOEPA to mandate inclusion; they pointed to legislative history that discusses the potential inclusion of credit insurance premiums if there is evidence that credit insurance premiums are being used to evade HOEPA. These commenters believe that a finding of evasion is a prerequisite to inclusion; they do not believe the standard has been met because the proposal merely noted that the change might prevent such evasions in the future. They also cited an exchange in the Congressional Record between two Senators, when the Congress was considering HOEPA legislation, about credit insurance being treated consistently with other provisions of TILA. Because premiums for optional credit insurance are not automatically included in the calculation of TILA's finance charge and APR, these commenters believe such premiums should not be included in HOEPA's points and fees calculation.

The commenters' suggestion that credit insurance premiums can only be included in the HOEPA trigger if the Board finds that creditors are using the premiums to evade HOEPA is directly contradicted by the express language of the statute, which states that the Board need only make a finding that this action is "appropriate." In construing a statute, the plain meaning of the

statutory text generally governs. When the plain meaning of the statutory language is clear, there is no reason to resort to legislative history. In this case, if the Congress had intended to make “evasions” the sole standard of “appropriateness” for including additional charges in the fee trigger, it would have done so expressly. For example, such language was used in section 129(1)(2)(A), which authorizes the Board to prohibit acts and practices that the Board finds to be “unfair, deceptive, or designed to evade” the provisions of HOEPA.

In light of the unambiguous statutory text, the Board believes that the legislative history cited by the commenters is not dispositive, and that evasion is merely one example of when the Board might find that inclusion of additional charges is “appropriate.” The Senate floor colloquy, which refers to HOEPA as being consistent with TILA’s treatment of insurance premiums, should not be construed as guidance on how the Board might, in the future, adjust HOEPA’s points and fees trigger. It merely clarified that optional credit insurance premiums were not automatically included in the statutory points and fees trigger, as would have been the case under an earlier version of the legislation.

Industry commenters opposed including optional credit insurance premiums in HOEPA’s points and fees trigger when, for purposes of TILA disclosures generally, the premiums are not included in the cost of the credit. The Board believes that HOEPA’s points and fees trigger is not intended to be the equivalent of the “cost of credit,” as measured by TILA’s finance charge and APR. Indeed, HOEPA expressly includes certain charges in the points and fees trigger that are not included in the finance charge, and authorizes the Board to include others. The HOEPA points and fees trigger is intended to be used to identify transactions with high costs where consumers may be vulnerable and thus need the benefit of HOEPA’s special protections.

Creditors also asserted that, based on typical premium rates, most mortgage loans that include single-premium credit insurance would be considered high-cost and thus would be covered

under HOEPA's fee-based trigger. As a result, they caution that lenders choosing not to make HOEPA loans would be foreclosed from offering single-premium credit insurance products to their loan customers. They asserted that the financing of single-premium insurance provides protection to cash-poor consumers who are underinsured, and in some cases offers less costly coverage compared with other forms of insurance. In short, these commenters generally support the current rule that does not include insurance premiums for optional credit insurance in the points and fees trigger. Alternatively, they recommend a rule that allows the insurance premiums to be excluded based on the consumers' ability to cancel the coverage and obtain a full refund, where consumers are also provided with adequate information about their rights to do so after the loan closing.

The Board believes that it is appropriate and consistent with the purposes of HOEPA to include premiums paid by consumers at or before closing for credit insurance (and other debt-protection products) in HOEPA's points and fee trigger. The coverage is purchased by the consumer in connection with the mortgage transaction, and the creditor or the credit account is the beneficiary. In addition, creditors receive commissions which may be significant for selling credit insurance (and retain the fee assessed for debt-cancellation coverage). This oftentimes represents a significant addition to the cost of the transaction to the borrower and an increase in benefit to the creditor. Moreover, when financed in connection with a subprime mortgage loan, as is typically the case, these charges can represent a significant addition to the loan balance, and thus, to the cost of the transaction and the size of the lien on the borrower's home. For example, according to insurance industry commenters, the typical cost of single-premium credit life insurance for an individual borrower could amount to the equivalent of several points. The total cost of credit insurance in a particular mortgage transaction, however, also depends on the number of borrowers covered, and the types of coverage purchased. HOEPA is specifically designed to help borrowers

in high-cost mortgage transactions to understand the costs of the transaction and that borrowers may lose their home if they do not meet the full amount of their obligation under the loan.

Importantly, anecdotal evidence has revealed that there are sometimes abuses associated with the sale and financing of single-premium credit insurance, which typically occurs in subprime loans. Some consumers are not aware that they are purchasing the insurance, some may believe the insurance is required, and some may not understand that the term of insurance coverage may be shorter than the term of the loan. The abuses and misunderstandings can be addressed somewhat by applying HOEPA's protections and remedies, to the extent that including insurance in the points and fees test brings these loans under HOEPA. Moreover, including credit insurance premiums in HOEPA's fee-based trigger prevents unscrupulous creditors from evading HOEPA by packing a loan with such products in lieu of charging other fees that already are included under the current HOEPA trigger.

One likely effect of this adjustment to the trigger is that significantly more of the loans that include single-premium insurance will be covered by HOEPA's protections. Data from a trade association of nondepository lenders indicate that lowering the APR trigger for first-lien loans by 2 percentage points and including optional credit insurance premiums in the points and fees tests would increase the percentage of first-lien mortgage loans covered by HOEPA, from 26 to 38 percent, for the firms surveyed. With a lowered APR trigger, coverage of subordinate-lien mortgage loans would increase from 47 to 61 percent for the firms surveyed.

When there are abuses such as coercive or deceptive sales practices, borrowers will benefit from HOEPA's rule requiring disclosures three days before closing. With the enhanced HOEPA disclosure of the amount borrowed, these consumers will receive advance notice about the additional amount they must borrow beyond their original loan request if they purchase the insurance. As part of that new disclosure, under the final rule, creditors must specify whether the

amount borrowed includes the cost of optional insurance. Moreover, creditors and assignees will be subject to HOEPA's strict liability and remedies when there are violations of law concerning the mortgage. See § 226.32(c)(5).

As commenters noted, some creditors choose not to make loans covered by HOEPA, and if these creditors have been offering single-premium insurance, they may decide to cease doing so in order to remain outside of HOEPA's coverage. To the extent that some creditors choose not to offer single-premium policies, they can make credit insurance available through other vehicles such as policies that assess and bill monthly premiums on the outstanding loan balance.

Industry commenters assert that single-premium policies are less costly than monthly premium insurance and provide greater continuity of coverage because a borrower's missed payments on the monthly-pay product might result in cancellation of insurance. Single-premium and monthly-premium policies have relative advantages and disadvantages. For example, a five-year policy with a financed single-premium may result in smaller monthly payments because the cost is spread over the full loan term, which may be ten or twenty years. But the consumer will also pay "points" (and interest over the life of the loan) on the additional amount financed for the coverage. Premiums assessed monthly, based on the outstanding loan balance, may result in a higher monthly expense, but they are not financed and would only be payable during the five years that coverage was in force, so the overall cost to the consumer could be lower. Regardless of the relative merits, under the final rule creditors will continue to have the ability to decide what types of insurance products they will make available to borrowers.

The final rule also provides guidance in calculating the HOEPA fees trigger. A mortgage loan is covered by HOEPA if the "points and fees" exceed 8 percent of the "total loan amount." The total loan amount is based on the "amount financed" as provided in § 226.18(b). Comment 32(a)(1)(ii)-1 of the staff commentary to Regulation Z discusses the calculation of the total loan

amount. The comment is revised, as proposed, to illustrate that premiums or other charges for credit life, accident, health, loss-of-income, or debt-cancellation coverage that are financed by the creditor must be deducted from the amount financed in calculating the total loan amount.

Disclosure alternatives — The Board solicited comment on whether optional credit insurance premiums should be excluded from the trigger when consumers have a right to cancel the policy and when disclosures about that right are provided after closing. Consumer representatives were opposed to the approach, expressing doubt that disclosures would be effective. Industry commenters supported the exclusion as a reasonable approach to address concerns about insurance packing. Upon further analysis, the Board believes that post-closing disclosures would be less effective than the HOEPA disclosures and remedies in deterring abusive sales practices in connection with insurance. Moreover, reliance on the consumer's exercise of their right to cancel the insurance would not prevent abuses but would unfairly require borrowers to take the initiative in remedying them.

### 32(c) Disclosures

Section 129(a) of TILA requires creditors offering HOEPA loans to provide abbreviated disclosures to consumers at least three days before the loan is closed, in addition to the disclosures generally required by TILA at or before closing. The HOEPA disclosures inform consumers that they are not obligated to complete the transaction and could lose their home if they take the loan and fail to make payments. The HOEPA disclosures also include a few key cost disclosures, such as the APR and the monthly payment (including the maximum payment for variable-rate loans and any balloon payment). Under the final rule these disclosures have been enhanced somewhat to further benefit borrowers. Section 226.32(c) is revised to provide, in accordance with TILA section 129(a), that the disclosures must be in a conspicuous type size.

32(c)(3) Regular Payment; Balloon Payment

Section 226.32(c)(3) requires creditors to disclose to consumers the amount of the regular monthly (or other periodic) payment, including any balloon payment. The regulation is revised to move the disclosure requirement for the amount of the balloon payment from the commentary to the regulation, to aid in compliance. Model Sample H-16, which illustrates the disclosures required under § 226.32(c), is revised to include a model clause on balloon payments.

Under comment 32(c)(3)-1 of the staff commentary, creditors are allowed to include voluntary items in the regular payment disclosed under § 226.32 only if the consumer has previously agreed to such items. The comment is revised for clarity as proposed.

Testimony at the Board's 2000 public hearings and other comments received suggest that some HOEPA disclosures provided in advance of closing include insurance premiums in the monthly payment, even though consumers may not agree to purchase optional insurance until closing. Consequently, the Board solicited comment on whether consumers should be required to request or affirmatively agree to purchase optional items in writing, to aid in enforcing the rule.

Some commenters supported having a rule where consumers would separately agree to purchase optional products. These commenters thought the rule would be useful in preventing "packing." Other commenters, representing both consumer and industry interests, opposed such an approach. The consumer representatives preferred creditors to have the duty to ensure "voluntariness." Industry representatives expressed a variety of concerns. Some believed that such a rule would be burdensome to creditors and borrowers alike, necessitating additional visits to sign the document at least three days before closing. They believed a separate affirmation to be duplicative and unnecessary. Others believed the rule would have the unintended effect of making consumers feel obligated, and ultimately less likely to reverse an earlier decision prior to or at closing.

Having carefully considered commenters' concerns regarding burden, and the effectiveness of a separate written agreement to purchase optional products to reduce "packing," the Board is not taking further action to require a separate written agreement at this time. To address insurance "packing," pursuant to its authority under section 129(l)(2)(B) of TILA, the Board has instead enhanced the final rule to require that the disclosure of the amount borrowed in mortgage refinancings expressly state whether optional credit insurance or debt-cancellation coverage is included in the amount financed, as discussed below.

The final rule for disclosing the "amount borrowed" includes a \$100 tolerance for minor errors. As discussed below, if the amount borrowed is inaccurate by any amount, the regular payment disclosure will be inaccurate also. To be meaningful to creditors, any tolerance for the amount borrowed must "pass through" to the regular payment. Such an approach is consistent with TILA's rule in closed-end transactions secured by real property or a dwelling, where the finance charge as well as other disclosures affected by the finance charge are considered accurate within prescribed limits. Pursuant to its authority under section 129(l)(2)(B) of TILA, the Board is providing a tolerance to the regular payment disclosure required under § 226.32(c)(3), if the payment disclosed is based on an amount borrowed that is deemed accurate and disclosed under § 226.32(c)(5).

#### 32(c)(5) Amount Borrowed

Section 226.32(c)(5) is added to require disclosure of the total amount the consumer will borrow, as reflected by the face amount of the note, pursuant to the Board's authority under Section 129(l)(2)(B) of TILA. This disclosure responds to concerns by consumers and consumer representatives that consumers sometimes seek a modest loan amount such as for medical or home improvement costs, only to discover at closing (or after) that the note amount is substantially higher due to fees and insurance premiums that are financed along with the requested loan amount.

The amount borrowed disclosure is enhanced in the final rule; when the loan amount includes premiums or other charges for optional credit insurance or debt-cancellation coverage, the disclosure must so specify, to address insurance “packing” where consumers may not be aware that insurance coverage has been added to the loan balance. Comment 32(c)(5)-1 to the staff commentary provides guidance regarding terminology for debt-cancellation coverage.

Consumer representatives and some industry representatives supported the proposal as aiding consumers’ understanding that additional fees might be financed. Other industry representatives opposed the proposal. Some of these commenters believed consumers would be confused by an “amount borrowed” in addition to TILA’s “amount financed,” which does not include amounts borrowed to cover loan fees.

Creditors must provide updated HOEPA disclosures if, after giving the disclosures required by § 226.32(c) to the consumer and before consummation, the creditor changes any terms that make the disclosure inaccurate. § 226.31(c)(1). The Board requested comment on whether it would be appropriate to provide for a tolerance for insignificant changes to the amount borrowed, and if so, what would be a suitable margin.

Commenters had mixed views on the desirability for a tolerance. Consumer groups supported either no tolerance or a very small tolerance such as \$100, consistent with the existing tolerance for understated finance charges in closed-end transactions secured by real property or a dwelling. § 226.18(d)(1). Industry commenters wanted a much larger tolerance such as 1 percent of the loan amount or 10 percent of the regular payment.

Pursuant to its authority under section 129(l)(2)(B) of TILA, the Board is providing a tolerance for the disclosure of the amount borrowed. Under the final rule, the amount borrowed is accurate if it is not more than \$100 above or below the amount required to be disclosed.

## Counseling

The Board requested comment on whether a generic disclosure advising consumers to seek independent advice might encourage borrowers to seek credit counseling. Consistent with views expressed in connection with the Board's 2000 hearings, both consumer and creditor commenters acknowledged the benefits of pre-loan counseling as a means to counteract predatory lending. There was uniform concern, however, about requiring a referral to counseling for HOEPA loans because the actual availability of local counselors may be uncertain. Based on the comments received and further analysis, the Board is not adopting a generic counseling disclosure at this time.

## 32(d) Limitations

### 32(d)(8) Due-on-demand Clause

As proposed, § 226.32(d)(8) is added to restrict the use of "due-on-demand" clauses or "call" provisions for HOEPA loans, unless the clause is exercised in connection with a consumer's default. The limitation on the use of these provisions in HOEPA loans is added pursuant to the Board's authority under section 129(l)(2)(A) to prohibit acts that are unfair or are designed to evade HOEPA. The staff commentary to § 226.32(d)(8) provides guidance concerning the exercise of due-on-demand clauses when a consumer fails to meet repayment terms or impairs the creditor's security for the loan.

Commenters generally supported the proposal. A few commenters suggested that the rule was not needed because they believe that due-on-demand clauses were generally not being used by mortgage lenders. Some industry commenters asked the Board to limit the rule's applicability to the first five years of a HOEPA loan, to coincide with HOEPA's ban on balloon payments. One commenter sought clarification that the rule limiting "due-on demand" clauses would not affect "due-on-sale" clauses.

The final rule is adopted as proposed. To prevent creditors from forcing consumers to pay additional points and fees to refinance their loans or face possible foreclosure, section 129(e) of TILA prohibits the use of balloon payments for HOEPA loans with terms of less than five years. Although “due-on-demand” and “call” provisions currently do not appear to be widely used in HOEPA loans, a creditor could potentially force the consumer to refinance by exercising the right to call the loan and demanding payment of the entire outstanding balance. Restricting call provisions in HOEPA loans is intended to ensure that lenders do not accelerate the payment of these loans, without cause, at any time during the loan term, in order to force consumers to refinance. When a creditor can unilaterally terminate the loan without cause, the consumer may be subject to unnecessary refinancings, excessive loan fees, higher interest rates, or possible foreclosure. Consequently, this rule prevents creditors from using call provisions in a manner that would cause substantial harm to HOEPA borrowers.

Loans covered by HOEPA are more likely to involve borrowers who have less-than-perfect credit histories, or who might not be served by prime lenders. As noted earlier, because these consumers either have or perceive they have fewer options than other borrowers, they may be more vulnerable to unscrupulous lenders or brokers. Accordingly, HOEPA includes limitations on certain loan provisions to protect these borrowers from onerous loan terms. The Board finds that it is also appropriate to protect HOEPA borrowers from the potentially harsh effects of allowing a creditor to exercise a “due-on-demand” clause at any time, unless there is legitimate cause.

The hearing testimony and comments received by the Board failed to identify any benefits to using due-on-demand clauses in HOEPA loans, other than in the legitimate cases that are permitted under the Board’s rule. The rule allows creditors to exercise such clauses when the creditor is faced with borrower misrepresentations or fraud, the borrower fails to meet repayment

terms, or a borrower's action (or failure to act) affects the creditor's security for the loan. The rule does not affect creditors' use of "due-on-sale" clauses.

The limitations on due-on-demand clauses adopted by the Board for HOEPA loans are similar to TILA's existing limits on the use of such clauses for home-equity lines of credit (HELOCs). See TILA, Section 127A; 12 CFR § 226.5b(f)(2). The rule for HELOCs is contained in the Home Equity Loan Consumer Protection Act of 1988 (Pub. Law No. 100-709, 102 Stat. 4725). The 1988 act recognized that allowing creditors to unilaterally terminate a home-equity line (or significantly change loan terms) is fundamentally unfair when the consumer's home is at stake. Allowing creditors' unlimited discretion to call the loan and require immediate repayment is similarly unfair with HOEPA loans.

#### **Section 226.34 — Prohibited Acts or Practices in Connection with Credit Secured by a Consumer's Dwelling**

Section 129(l) of TILA authorizes the Board to prohibit acts or practices to curb abusive lending practices. The act provides that the Board shall prohibit practices: (1) in connection with all mortgage loans if the Board finds the practice to be unfair, deceptive, or designed to evade HOEPA; and (2) in connection with refinancings of mortgage loans if the Board finds that the practice is associated with abusive lending practices or otherwise not in the interest of the borrower. The Board is exercising this authority to prohibit certain acts or practices, as discussed below. The final rule is intended to curb unfair or abusive lending practices without unduly interfering with the flow of credit, creating unnecessary creditor burden, or narrowing consumers' options in legitimate transactions. The rule prohibiting "loan flipping" has been modified to expand its scope. The rule protecting low-rate loans has not been adopted due to concerns about the compliance burden on the home-equity lending market generally. Other provisions have been adopted as proposed.

The final rule creates a new § 226.34, which contains prohibitions against certain acts or practices in connection with credit secured by a consumer's dwelling. This section includes the rules currently contained in § 226.32(e).

#### 34(a) Prohibited Acts or Practices for Loans Subject to ¶ 226.32

##### 34(a)(1) Home Improvement Contracts

Section 226.32(e)(2) regarding home-improvement contracts is renumbered as ¶ 226.34(a)(1) without substantive change. Comment 32(e)(2)(i)-1 of the staff commentary is now comment 34(a)(1)(i)-1.

##### 34(a)(2) Notice to Assignee

Section 226.32 (e)(3) regarding assignee liability for claims and defenses that consumers may have in connection with HOEPA loans is renumbered as ¶ 226.34(a)(2) without substantive change. Comments 32(e)(3)-1 and -2 are now comments 34(a)(2)-1 and -2 respectively.

Comment 34(a)(2)-3 is added to clarify the statutory provision on the liability of purchasers or other assignees of HOEPA loans, as proposed. Section 131 of TILA provides that, with limited exceptions, purchasers or other assignees of HOEPA loans are subject to all claims and defenses with respect to a mortgage that the consumer could assert against the creditor. The comment clarifies that the phrase "all claims and defenses" is not limited to violations of TILA as amended by HOEPA. This interpretation is based on the statutory text and is supported by the legislative history. See Conference Report, Joint Statement of Conference Committee, H. Rep. No. 103-652, at 22 (Aug. 2, 1994).

##### 34(a)(3) Refinancings Within One-year Period

"Loan flipping" generally refers to the practice by brokers and creditors of frequently refinancing home-secured loans to generate additional fee income even though the refinancing is

not in the borrower's interest. Loan flipping is among the more flagrant of lending abuses. Victims tend to be borrowers who are having difficulty repaying a high-cost loan; they are targeted with promises to refinance the loan on more affordable terms. The refinancing typically provides little benefit to the borrower, as the loan amount increases mostly to cover fees. Often, there is minimal or no reduction in the interest rate. The monthly payment may increase, making the loan even more unaffordable. Sometimes the loan is amortized so that the monthly payment is reduced, but the loan may still be unaffordable. As long as there is sufficient equity to support the financing of additional fees, the consumer may be targeted repeatedly, resulting in equity stripping.

The proposed rule prohibited an originating creditor (or assignee) holding a HOEPA loan from refinancing that loan into another HOEPA loan within the first twelve months following origination, unless the new loan was "in the borrower's interest." Pursuant to its authority under Section 129(l)(2)(A) of TILA, the Board is adopting a final rule to address "loan flipping," as discussed below.

Consumer representatives generally supported the proposal, but they believed the rule was too narrow and that all creditors and brokers should be covered. Federal agencies, community groups, and consumers and their representatives believe that the prohibition should be lengthened; suggestions ranged from 18 months to as long as four years.

Creditors' comments mainly focused on the "interest of the borrower" test. Both creditors and consumer representatives sought additional guidance in this area. Consumer representatives viewed the standard as too lenient, while creditors believed that the standard's lack of certainty would subject them to litigation risk. Creditors also expressed concerns about the proposal's coverage of affiliates and sought clarification about whether an assignee merely servicing HOEPA loans is covered by the rule.

The Board is adopting a final rule that broadens the proposal's coverage somewhat. Under the final rule, within the first twelve months of originating a HOEPA loan to a borrower, the creditor is prohibited from refinancing that loan (whether or not the creditor still holds the loan) or another HOEPA loan held by that borrower.

The proposal was narrowly tailored to curb the more egregious cases of loan flipping: repeated refinancing by creditors that hold HOEPA loans in portfolio. Once a creditor assigned the loan, the assignee would have been covered, but the originating creditor could then have refinanced the HOEPA loan. Thus, the proposed rule did not cover loan originators that close loans in their own name and immediately assign them to a funding party or sell them in the secondary market. The hearing testimony and comments suggest that some of these originators are the source of unaffordable loans because they do not have a vested interest in the borrower's ability to repay the loan. Once they are no longer holding a loan, they can target the same borrower with an offer to refinance the loan. The final rule has been expanded to cover creditors (including brokers) that originate HOEPA loans, whether or not they continue to hold the loan. The loan flipping rule may deter some unaffordable lending if the parties making, holding, or servicing the loan are not permitted to refinance the loan within the first year.

Assignees are covered by the rule because in some instances they are the "true creditor" funding the loan. Even when they are not acting as the true creditors, assignees of HOEPA loans are subject to the refinancing restrictions to ensure that loans are not transferred for the purpose of evading the prohibition and that borrowers are not pressured into frequent refinancings by the party holding or servicing their loans. Thus, the rule has been revised to clarify that it applies to assignees that are servicing a HOEPA loan, whether or not they own the obligation. Assignees will be under the same restrictions as the original creditor while holding or servicing the loan.

Comment 34(a)(3)-2 of the staff commentary is added to provide examples of how the rule is applied in specific cases.

Under the proposal, the regulatory prohibition applicable to creditors would have applied to their affiliates in all cases. Industry commenters were concerned about the compliance burden—particularly for creditors with broad geographic and corporate structures. The final rule has been narrowed and would not apply in routine cases where consumers seek a refinancing from an affiliate. Under the final rule, loans made by an affiliate are prohibited only if the creditor engages in a pattern or practice of arranging loans with an affiliate to evade the flipping prohibition, or engages in other acts or practices designed to evade the rule. The final rule also prohibits creditors from arranging refinancings of their own loans with unaffiliated creditors to evade the flipping prohibition.

As noted above, some commenters believe that the prohibition should be lengthened. Although a longer period might further limit the opportunity for loan flipping, one year provides an appropriate balance between the need to address the clearest cases of abusive refinancings and the need not to restrict the free flow of credit in legitimate transactions. Thus, the final rule retains the one-year limitation, as proposed.

Borrower's interest — Under the proposal, creditors are permitted to refinance a HOEPA loan within the one-year period when “in the borrower’s interest.” The determination of whether or not a benefit exists would be based on the totality of the circumstances. Consumer representatives viewed the standard as too lenient. They asserted that the lack of specificity or examples under the proposal would lead creditors to liberally construe the “borrower’s interest” standard to permit any borrower predicament or any arguable “improvement” in term, payment, or rate, as sufficient justification for refinancing within the first year. Creditors, conversely, believed that the standard’s lack of certainty would lead to litigation, inconsistent application, and borrower

and judicial second-guessing of creditors. This, creditors argued, could ultimately result in a hesitancy by creditors to extend refinance credit at all in the first year of origination of a HOEPA loan.

Commenters offered many suggestions for more specific guidance, asking the Board to provide that lowering the interest rate or the monthly payment, or eliminating a balloon payment or variable rate feature, was per se, “in the borrower’s interest.” Although a list of acceptable loan purposes would provide more certainty, it is difficult to identify circumstances that would be unequivocally in the borrower’s interest in all or even most cases. A good reason in one context may be abusive in other circumstances. For example, a homeowner’s equity could still be stripped through repeated refinancings that carry high up-front fees even if they result in incrementally lower APRs.

The Board believes that precisely defining circumstances that are “in the borrower’s interest” is not necessary, given the nature of the loan flipping prohibition. The prohibition applies for a relatively short period, and is intended as a strong deterrent for the more egregious cases. The “borrower’s interest” exception must be narrowly construed to preserve the effectiveness of the overall prohibition. Moreover, the probability that a legitimate creditor would refinance its own HOEPA loans within twelve months is typically low.

The Board recognizes that this approach places the primary burden on the creditor, in light of the totality of the circumstances, to weigh whether the loan is in the borrower’s interest. The standard is intended to give legitimate creditors some flexibility for extenuating circumstances, while creditors that rely on the exception routinely to “flip” HOEPA loans bear the risk that a court will find that they violated HOEPA.

Comment 34(a)(3)-1 of the staff commentary has been expanded to provide additional guidance on lenders’ ability to make loans that are in the borrower’s interest notwithstanding the

loan-flipping prohibition. A mere statement by the borrower that “this loan is in my interest” would not meet the standard. In connection with a refinancing that provides additional funds to the borrower, in determining whether a refinancing is in the borrower’s interest, consideration should be given to whether the loan fees and charges are commensurate with the amount of new funds advanced, and whether the real estate-related charges are bona fide and reasonable in amount (see generally § 226.4(c)(7)). A refinancing would be in the borrower’s interest if needed for a “bona fide personal financial emergency”; this is the current standard for certain consumer waivers under TILA. TILA authorizes the Board to permit consumers to waive the three-day rescission period for certain home equity loans or the three-day waiting period before closing a HOEPA loan, if necessary for homeowners to meet a bona fide personal financial emergency. See § 226.23(e) and § 226.31(c)(1)(iii). Comment 31(c)(1)(iii)-1 of the staff commentary provides that the imminent sale of the consumer’s home at foreclosure during the three-day HOEPA waiting period is an example of a bona fide personal financial emergency.

Limitations on refinancing low-rate loans. The December proposal addressed abuses involving the refinancing of low-rate loans originated through mortgage assistance programs designed to give low- or moderate-income borrowers the opportunity for homeownership. Some of these homeowners who have unsecured debts have been targeted by unscrupulous lenders who consolidate the debts and replace the low-cost, first-lien mortgage with a substantially higher cost loan. The replacement loans are often unaffordable, many involve “loan flipping,” and as a result, homeowners have lost their homes. In some cases, the low-cost loan is replaced even though the first-lien holder may be willing to subordinate its security interest.

Under the proposal creditors would have been prohibited, in the first five years of a zero interest rate or other low-rate loan, from replacing that loan with any higher-rate loan unless the refinancing was in the interest of the borrower. Based on the comments received and after

consultation with the Consumer Advisory Council and further analysis, the Board is withdrawing the proposal.

Unlike the prohibition against loan flipping, which applies only to HOEPA creditors, the prohibition against refinancing low-cost loans, as proposed, would have applied to all mortgage refinancing transactions. While borrowers with low-cost mortgage loans could benefit from the rule, the benefits appear to be far outweighed by the potential compliance burden for all home-equity lenders. Therefore, the proposed rule is being withdrawn at this time. If problems persist, the Board could consider in a future rulemaking approaches that appropriately protect such borrowers without creating undue burdens for creditors.

#### 34(a)(4) Repayment Ability

Under section 129(h) of TILA, a creditor may not engage in a pattern or practice of making HOEPA loans based on the equity in the borrower's home without regard to the consumer's repayment ability, taking into account the consumer's current and expected income, current obligations, and employment status. As proposed, the final rule, formerly in § 226.32(e)(1), has been moved to § 226.34(a)(4) and revised to parallel the statutory language. The revision is a clarification of existing law and is not a new rule.

Currently, compliance with the prohibition against unaffordable lending is difficult to enforce because creditors are not required to document that they considered the consumer's ability to repay. In addition, there have been reports of creditors relying on inaccurate information provided by unscrupulous loan brokers. To aid in solving these problems, the Board proposed under § 226.34(a)(4)(ii) to require that creditors generally verify and document consumers' current or expected income, current obligations, and employment to the extent applicable. If a creditor engages in a pattern or practice of making loans without verifying and documenting consumers'

repayment ability, there would be a presumption that the creditor has violated the rule. The Board adopts the rule as § 226.34(a)(4) with minor modifications.

Determining repayment ability — Comment 34(a)(4)-1 of the staff commentary, formerly comment 32(e)(1)-1, has been modified in light of the new verification and documentation requirements discussed below.

The reference to § 226.32(d)(7) has been deleted as unnecessary; the sources of information listed in § 226.32(d)(7) with one exception are listed in comment 34(a)(4)-2 on verifying and documenting repayment ability.

Verification and documentation — The verification and documentation rule requires creditors to use independent sources to ascertain borrowers' ability to repay loans that are secured by their homes, and to memorialize and retain this information. Proposed comment 34(a)(4)(ii)-1 provided examples of ways to verify and document the income and obligations of consumers who are employed, including those who are self-employed. The final comment, renumbered 34(a)(4)-4, adopts the proposed comment with modifications to accommodate creditworthy borrowers not employed or without traditional financial documents.

Most of the commenters supported the rule and comment. Some commenters from industry pointed out that verification and documentation is basic to the underwriting process and already required for safety and soundness purposes. Government entities at both the federal and state levels noted that verification and documentation is necessary for enforcement of the prohibition against unaffordable mortgage lending. A few commenters were concerned that the rule was not sufficiently flexible in allowing creditors to make loans to creditworthy borrowers whose repayment ability may not be based on regular employment wages. The final comment clarifies that creditors can rely on any reliable source that provides a reasonable basis for believing there are sufficient funds to support repayment of the loan.

Pattern or practice — Section 129(h) of TILA does not define “pattern or practice,” nor does the legislative history provide guidance as to how the phrase should be applied. The Board proposed interpretive guidance on the “pattern or practice” requirement. The proposed comment provided that determining whether a pattern or practice exists depends on the totality of the circumstances. The proposal referenced statutes relevant to a pattern or practice determination, specifically, the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Housing Act, and Title VII of the Civil Rights Act of 1964 (equal employment opportunity).

Those that commented on this aspect of the proposal generally requested more guidance on what would constitute a “pattern or practice.” Several requested that the Board set a specific standard. Industry commenters generally preferred a narrow standard, while representatives of consumer and community groups sought a broader standard that would be less onerous for consumers. Comment 34(a)(1)-2 as adopted provides additional guidance on the “pattern or practice” requirement, but retains the totality of the circumstances test. The comment provides that while a “pattern or practice” of violations is not established by isolated, random, or accidental acts, it can be established without the use of a statistical process. The comment also notes that a creditor might act under a lending policy (whether written or unwritten) and that action alone could establish that there is a pattern or practice of violating the prohibition against unaffordable lending.

Discounted introductory rates — Concern was raised about creditors determining a consumer’s repayment ability based on low introductory rates offered under some programs. Proposed comment 34(a)(4)(i)-3 provided that in considering consumers’ repayment ability in transactions where the creditor sets a temporary introductory interest rate and the rate is later adjusted (whether fixed or later determined by an index or formula) the creditor must consider increases in the consumer’s payments assuming the maximum possible increases in rates in the

shortest possible time frame. The comment was not intended to impose a standard for evaluating a borrower's repayment ability that is more stringent than current industry practice. While creditors typically do not evaluate a borrower's ability to repay a loan based on a temporary discounted rate, they also do not evaluate repayment ability based on the maximum interest rate that may be charged as a result of rate adjustments on the loan. Based on the comments and further analysis, the final comment treats all discounted and variable-rate loans the same. Comment 34(a)(4)-3, as adopted, requires creditors to consider the consumer's ability to repay the loan assuming the non-discounted rate for fixed-rate loans, or the fully-indexed rate for variable rate loans, is in effect at consummation.

#### 34(b) Prohibited Acts or Practices for Dwelling-secured Loans; Open-end Credit

HOEPA covers only closed-end mortgage loans. In the December notice, the Board proposed a prohibition against structuring a home-secured loan as a line of credit to evade HOEPA's requirements, if the credit does not meet the definition of open-end credit in § 226.2(a)(20).

Although consumer representatives supported the Board's proposal, they generally believe that HOEPA should cover open-end credit carrying rates or fees above HOEPA's price triggers. Industry commenters believe there is little evidence that creditors are using open-end credit to evade HOEPA. Moreover, they oppose the rule as unnecessary because it is already a violation of TILA to provide disclosures for an open-end credit plan if the legal obligation does not meet the criteria for open-end credit.

Pursuant to the Board's authority under section 129(l)(2)(A), as proposed, § 226.34(b) explicitly prohibits structuring a mortgage loan as an open-end credit line to evade HOEPA's requirements, if the loan does not meet the TILA definition of open-end credit. This prohibition responds to cases reported by consumer advocates at the Board's hearings and to enforcement

actions brought by the Federal Trade Commission, where creditors have documented loans as open-end “revolving” credit, even if there was no real expectation of repeat transactions under a reusable line of credit. Although the practice would currently violate TILA, the new rule will subject creditors and assignees to HOEPA’s stricter liability rule and remedies if the credit carries rates and fees that exceed HOEPA’s price triggers for closed-end loans.

Where a loan is documented as open-end credit but the features and terms or other circumstances demonstrate that it does not meet the definition of open-end credit, the loan is subject to the rules for closed-end credit, including HOEPA if the rate or fee trigger is met. In response to comments, comment 34(b)-1 provides guidance on how to apply HOEPA’s triggers to transactions structured as open-end credit in violation of § 226.34(b).

#### **Appendix H to Part 226 — Closed-end Model Forms and Clauses**

Model Form H-16—Mortgage Sample illustrates the disclosures required by § 226.32(c), which must be provided to consumers at least three days before becoming obligated on a mortgage transaction subject to § 226.32. Model Form H-16 is amended to illustrate the additional disclosures required for refinancings under § 226.32(c)(5). A new comment App. H-20 clarifies that although the additional disclosures are required for refinancings that are subject to § 226.32, creditors may, at their option, include these disclosures for any loan subject to that section. The Sample also includes an illustration for loans with balloon payments. Former comments H-20 through H-23 have been renumbered H-21 through H-24, respectively.

#### **IV. Regulatory Flexibility Analysis**

The Regulatory Flexibility Act (5 U.S.C.601 *et seq.*) requires federal agencies either to provide a Final Regulatory Flexibility Analysis with a final rule or to certify that the final rule will not have a significant economic impact on a substantial number of small entities. Based on available data, the Board is unable to determine at this time whether the final rule would have a

significant impact on a substantial number of small entities. For this reason, the Board has prepared the following Final Regulatory Flexibility Analysis.

(1) Statement of the need for and objectives of the final rule — The final rule is adopted to address predatory lending and unfair practices in home-equity lending. As stated more fully above, the existing regulations are amended to broaden the scope of mortgage loans subject to HOEPA by adjusting the price triggers used to determine coverage under the act (both the interest rate trigger and points and fees trigger). Certain acts and practices in connection with home-secured loans are restricted. For example, creditors may not engage in repeated refinancings of HOEPA loans over a short time period when the transactions are not in the borrower's interest. HOEPA's prohibition against extending credit without regard to consumers' repayment ability is strengthened, and disclosures received by consumers before closing for HOEPA-covered loans are also enhanced.

(2) Summary of public comment and statement of changes — Significant issues raised by the public comments in response to the Board's proposal and Initial Regulatory Flexibility Analysis are described more fully in the supplementary material provided above.

Section 103(f) of TILA provides that a person becomes a creditor under TILA if, during any twelve-month period, the person originates more than one HOEPA-covered loan, or one or more HOEPA-covered loans through a mortgage broker. In providing protections to consumers whose principal dwellings secure high-cost mortgage loans, HOEPA did not create different rules for large and small creditors. Moreover, HOEPA sets forth specific limitations on the Board's authority to exempt mortgage products or categories of products from certain of HOEPA's requirements. See Section 129(l)(1) of TILA. Nevertheless, the Board has analyzed comments and has sought to minimize compliance burden for all creditors by making modifications to the proposal in the following ways.

- Tiered APR trigger — The final rule retains the current APR trigger for subordinate-lien loans at 10 percentage points above the rate for Treasury securities having a comparable maturity. The proposed across-the-board reduction of the APR trigger to 8 percentage points for all loans encompassed subordinate-lien loans that fall between the 8 and 10 percentage point triggers. The final revision to the APR trigger reduces the impact of the rule on creditors that choose not to extend HOEPA-covered credit generally, and on those that make small, short-term home-equity loans in particular, where fixed origination costs may significantly impact the APR.
- Safe-harbor for refinancings in the “borrower’s interest” — The final rule provides additional guidance on creditors’ ability to refinance a HOEPA loan into another HOEPA loan that is in the borrower’s interest notwithstanding the one-year general prohibition on such refinancings. Creditors expressed concern that the proposed determination for meeting the standard—the totality of the circumstances—was too subjective, and that as a result creditors would refrain from making refinancings during the one-year period to avoid litigation risk. In addition to providing additional guidance on refinancings that would be in the borrower’s interest, the final rule permits creditors to make an additional subordinate-lien HOEPA loan that is not a refinancing to the same borrower.
- Low-cost loan refinancing — The proposed prohibition against refinancing certain low-cost loans is withdrawn. The relatively low number of borrowers with low-cost mortgage loans that would benefit from the rule appeared to be far outweighed by the compliance burden for all home-equity lenders.
- Tolerance for amount borrowed — The final rule, as proposed, requires creditors making HOEPA-covered refinancings to include the face amount of the note (“amount borrowed”) in the HOEPA disclosures provided at least three days before closing. If any term is changed between the time the early HOEPA disclosure is provided to the consumer and consummation,

and the change makes the disclosure inaccurate, new disclosures must be provided and another three-day waiting period begins. The final rule contains a small tolerance for changes in the amount actually borrowed of \$100 above or below the amount disclosed, and to the disclosed regular payment as it is affected by the disclosed amount borrowed. This reduces redisclosure duties for creditors making insignificant errors and mitigates the economic impact of the rule's overall compliance burdens and costs.

(3) Description of the small entities to which the final rule would apply — The number of lenders, large or small, likely to be affected by the proposal is unknown. In the June 2001 Call Report, 4,547 small banks (assets less than \$100 million) had first-lien mortgage credit outstanding, and 3,477 small banks had junior-lien mortgage loans outstanding. At the same time there were 228 small thrifts that report to the Office of Thrift Supervision which had closed-end first mortgage credit and/or junior-lien loans outstanding. The number of banks or thrifts active in subprime lending or HOEPA loans cannot be determined from information in the Call Report.

There is no comprehensive listing of consumer finance companies, but informal industry contacts indicate that there may be about 2,000 such institutions nationwide. Most of these companies are small entities, but apparently many, perhaps most, of the small institutions do not engage in mortgage lending, preferring to concentrate on unsecured lending and sales finance. An unknown number of small institutions do engage in mortgage lending, but there is no comprehensive listing of these institutions or estimate of their number.

There also is no comprehensive listing of mortgage banks or mortgage brokers, but informal discussions with industry sources indicate that there are more than 1,200 mortgage banking firms with annual mortgage originations of less than \$100 million that are members of a national trade association. Some of these companies are primarily mortgage servicing companies

and generate few or no new mortgages, but there is also an unknown number of other mortgage banks that do not belong to the association.

The effect of expanding HOEPA coverage on small entities is unknown. The precise effect that adjusting the triggers will have on creditors' business strategies is difficult to predict. As discussed in the supplementary information provided above, there is an active market for HOEPA loans under the current triggers. Some creditors that choose not to make HOEPA loans may withdraw from making loans in the range of rates that would be covered by the lowered threshold. Others creditors may fill any void left by creditors that choose not to make HOEPA loans. And others may have the flexibility to avoid HOEPA's coverage by lowering rates or fees for some loans at the margins, consistent with the risk involved.

(4) Reporting, recordkeeping, and compliance requirements — The final amendments: (1) extend the protections of HOEPA to more loans; (2) strengthen HOEPA's prohibition on loans based on homeowners' equity without regard to repayment ability; (3) improve disclosures received by consumers before closing; and (4) prohibit certain acts or practices, to address some "loan flipping" within the first twelve months of a HOEPA loan by prohibiting a refinancing into another HOEPA loan to the same borrower unless the refinancing is in the borrower's interest. HOEPA applies to creditors that make more than one HOEPA loan in a twelve-month period. For firms engaged in subprime lending, HOEPA's existing scope of coverage, its prohibition on loans made without regard to consumers' repayment ability, and its mandatory pre-closing disclosures already require the professional skills needed to comply with HOEPA. For some creditors (or holders or servicers of HOEPA loans) that seek to refinance a HOEPA loan with the same borrower into another HOEPA loan during a one-year period after origination, some recordkeeping adjustments may be necessary. However, the Board believes the burden will not be significant, since each of these parties has records that associate the borrower and the loan date for purposes of

the one-year prohibition. Also, while the final rule imposes a new requirement to document and verify consumers' repayment ability for HOEPA loans, the Board believes that creditors' existing consideration of safety and soundness issues and risk assessment will result in little additional burden to comply with the new requirements.

Institutions that originate subprime mortgages, including small entities, will have to become aware of new definitions that expand HOEPA coverage, and as needed, will have to comply with the additional disclosures and other consumer protection provisions that apply to HOEPA loans. To comply with the final rule, then, creditors will need, among other things, to prepare disclosure forms, make various operational changes, and train staff. Professional skills needed to comply with the final rule may include clerical, computer systems, personnel training, as well as legal advice, which will require internal review and other actions by programmers and systems specialists, employee trainers, attorneys, and senior managers. Significantly, however, these skills are currently required to comply with HOEPA's existing rules and are not new to creditors both large and small. Creditors can reasonably be expected to be able to rely on current personnel for these specialized skills and thus not experience undue compliance burden.

(5) Significant alternatives to the final rule — As explained above, the final rule is adopted substantially as proposed to address predatory lending and unfair practices in the home-equity market, and contains several revisions to reflect suggestions or alternatives recommended by commenters. Specifically, the adoption of a “tiered” APR trigger, the inclusion of a tolerance for insignificant errors in disclosing the amount borrowed, the additional guidance for meeting the “borrower’s interest” standard under the refinancing restriction, and the withdrawal of the “low-cost loan” refinancing prohibition, all reflect an effort to incorporate practical measures to reduce compliance burdens for creditors. The rule’s amendments are issued pursuant to the Board’s authority under TILA to adjust the scope of mortgage loans covered by HOEPA, to prohibit certain

acts or practices affecting mortgage loans or refinancings, to effectuate the purposes of TILA, to prevent circumvention or evasion, or to facilitate compliance. The amendments are intended to target unfair or abusive lending practices without unduly interfering with the flow of credit, creating unnecessary credit burden, or narrowing consumers' options in legitimate credit transactions. The final rule contains specific modifications to the proposed rule that reduce regulatory burden.

#### **V. Paperwork Reduction Act**

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the rule under the authority delegated to the Board by the Office of Management and Budget. The Federal Reserve may not conduct or sponsor, and an organization is not required to respond to, this information collection unless it displays a currently valid OMB control number. The OMB control number is 7100-0199.

The collection of information that is revised by this rulemaking is found in 12 CFR part 226 and in Appendices F, G, H, J, K, and L. This information is mandatory (15 U.S.C. 1601 et seq.) to evidence compliance with the requirements of Regulation Z and the Truth in Lending Act (TILA). The respondents/recordkeepers are all types of creditors, among which are small businesses. Under the Paperwork Reduction Act, the Federal Reserve accounts for the paperwork burden associated with Regulation Z only for state member banks, their subsidiaries, and subsidiaries of bank holding companies (not otherwise regulated). Other agencies account for the paperwork burden on their respective constituencies under this regulation. Institutions are required to retain records for twenty-four months.

The final rule broadens HOEPA's coverage (by lowering the APR trigger for first-lien loans by 2 percentage points and adding certain costs to the fee-based trigger) and revises a disclosure currently required by § 226.32 of Regulation Z. The revised disclosure covers

refinancings subject to HOEPA and states the total amount of the borrower's obligation and whether optional credit insurance or debt-cancellation coverage is included in the amount borrowed (§ 226.32(c)(5)). Model Form H-16 illustrates this revised disclosure. The burden of revising the disclosure should be minimal because most institutions use software that automatically generates model forms such as Model Form H-16. The changes to the triggers also should impose minimal burden because the changes generally will require only a one-time reprogramming of systems.

With respect to state member banks, it is estimated that there are 976 respondent/recordkeepers and an average frequency of 136,294 responses per respondent each year for Regulation Z. Therefore, the total annual burden under the regulation for all state member banks is estimated to be 1,841,118 hours. In the Federal Reserve's April 2001 Paperwork Reduction Act submission to OMB addressing the electronic disclosures interim rule, the Federal Reserve stated its belief that state member banks do not typically offer the type of loans that would require HOEPA disclosures and that these disclosures had a negligible effect on the paperwork burden for state member banks. Lowering the APR trigger by 2 percentage points could, however, result in higher burden for the few state member banks that choose to make these loans. Because little information is available about the actual number of loans that will be affected by the coverage change the Federal Reserve is not changing its current burden estimates cited above. The Federal Reserve will, however, solicit more burden comments and re-estimate the burden associated with the HOEPA requirements in Regulation Z in the next triennial PRA review (during the fourth quarter 2002). The Federal Reserve also estimates the one-time cost burden for programming systems with the revised disclosures and updating systems with the new triggers to be \$135,000 per bank, on average.

Because the records are maintained at state member banks and the notices are not provided to the Federal Reserve, no issue of confidentiality under the Freedom of Information Act arises; however, any information obtained by the Federal Reserve may be protected from disclosure under exemptions (b)(4), (6), and (8) of the Freedom of Information Act (5 U.S.C. 522 (b)(4), (6) and (8)). The disclosures and information about error allegations are confidential between creditors and the customer.

The Federal Reserve has a continuing interest in the public's opinions of our collections of information. At any time, comments regarding the burden estimate, or any other aspect of this collection of information, including suggestions for reducing the burden, may be sent to: Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, DC 20551; and to the Office of Management and Budget, Paperwork Reduction.

#### **List of Subjects in 12 CFR Part 226**

Advertising, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Truth in lending.

For the reasons set forth in the preamble, the Board amends Regulation Z, 12 CFR part 226, as set forth below:

#### **PART 226 — TRUTH IN LENDING (REGULATION Z)**

1. The authority citation for part 226 continues to read as follows:

**Authority:** 12 U.S.C. 3806; 15 U.S.C. 1604 and 1637(c)(5).

##### Subpart A—General

2. Section 226.1 is amended by:
  - a. Revising paragraph (b); and
  - b. Revising paragraph (d)(5).

**§ 226.1 Authority, purpose, coverage, organization, enforcement and liability.**

\* \* \* \* \*

(b) Purpose. The purpose of this regulation is to promote the informed use of consumer credit by requiring disclosures about its terms and cost. The regulation also gives consumers the right to cancel certain credit transactions that involve a lien on a consumer's principal dwelling, regulates certain credit card practices, and provides a means for fair and timely resolution of credit billing disputes. The regulation does not govern charges for consumer credit. The regulation requires a maximum interest rate to be stated in variable-rate contracts secured by the consumer's dwelling. It also imposes limitations on home equity plans that are subject to the requirements of § 226.5b and mortgages that are subject to the requirements of § 226.32. The regulation prohibits certain acts or practices in connection with credit secured by a consumer's principal dwelling.

\* \* \* \* \*

(d) Organization. \* \* \*

(5) Subpart E contains special rules for mortgage transactions. Section 226.32 requires certain disclosures and provides limitations for loans that have rates and fees above specified amounts. Section 226.33 requires disclosures, including the total annual loan cost rate, for reverse mortgage transactions. Section 226.34 prohibits specific acts and practices in connection with mortgage transactions.

\* \* \* \* \*

**Subpart E—Special Rules for Certain Home Mortgage Transactions**

3. Section 226.32 is amended by:
  - a. Republishing paragraph (a)(1) introductory text and revising paragraph (a)(1)(i);
  - b. Republishing paragraphs (b) introductory text and (b)(1)(i) through (iii) and adding paragraph (b)(1)(iv);

c. Republishing paragraph (c) introductory text, revising the heading and paragraph (c)(3), and adding paragraph (c)(5);

d. Revising paragraph (d) introductory text and adding paragraph (d)(8); and

e. Removing paragraph (e).

**§ 226.32 Requirements for certain closed-end home mortgages.**

(a) Coverage.

(1) Except as provided in paragraph (a)(2) of this section, the requirements of this section apply to a consumer credit transaction that is secured by the consumer's principal dwelling, and in which either:

(i) The annual percentage rate at consummation will exceed by more than 8 percentage points for first-lien loans, or by more than 10 percentage points for subordinate-lien loans, the yield on Treasury securities having comparable periods of maturity to the loan maturity as of the fifteenth day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor; or

\* \* \* \* \*

(b) Definitions. For purposes of this subpart, the following definitions apply:

(1) For purposes of paragraph (a)(1)(ii) of this section, points and fees means:

(i) All items required to be disclosed under § 226.4(a) and 226.4(b), except interest or the time-price differential;

(ii) All compensation paid to mortgage brokers;

(iii) All items listed in § 226.4(c)(7) (other than amounts held for future payment of taxes) unless the charge is reasonable, the creditor receives no direct or indirect compensation in connection with the charge, and the charge is not paid to an affiliate of the creditor; and

(iv) Premiums or other charges for credit life, accident, health, or loss-of-income insurance, or debt-cancellation coverage (whether or not the debt-cancellation coverage is insurance under applicable law) that provides for cancellation of all or part of the consumer's liability in the event of the loss of life, health, or income or in the case of accident, written in connection with the credit transaction.

\* \* \* \* \*

(c) Disclosures. In addition to other disclosures required by this part, in a mortgage subject to this section, the creditor shall disclose the following in conspicuous type size:

\* \* \* \* \*

(3) Regular payment; balloon payment. The amount of the regular monthly (or other periodic) payment and the amount of any balloon payment. The regular payment disclosed under this paragraph shall be treated as accurate if it is based on an amount borrowed that is deemed accurate and is disclosed under paragraph (c)(5) of this section.

\* \* \* \* \*

(5) Amount borrowed. For a mortgage refinancing, the total amount the consumer will borrow, as reflected by the face amount of the note; and where the amount borrowed includes premiums or other charges for optional credit insurance or debt-cancellation coverage, that fact shall be stated, grouped together with the disclosure of the amount borrowed. The disclosure of the amount borrowed shall be treated as accurate if it is not more than \$100 above or below the amount required to be disclosed.

\* \* \* \* \*

(d) Limitations. A mortgage transaction subject to this section shall not include the following terms:

\* \* \* \* \*

(8) Due-on-demand clause. A demand feature that permits the creditor to terminate the loan in advance of the original maturity date and to demand repayment of the entire outstanding balance, except in the following circumstances:

(i) There is fraud or material misrepresentation by the consumer in connection with the loan;

(ii) The consumer fails to meet the repayment terms of the agreement for any outstanding balance; or

(iii) There is any action or inaction by the consumer that adversely affects the creditor's security for the loan, or any right of the creditor in such security.

\* \* \* \* \*

5. A new § 226.34 is added to read as follows:

**§ 226.34 Prohibited acts or practices in connection with credit secured by a consumer's dwelling.**

(a) Prohibited acts or practices for loans subject to § 226.32. A creditor extending mortgage credit subject to § 226.32 shall not —

(1) Home improvement contracts. Pay a contractor under a home improvement contract from the proceeds of a mortgage covered by § 226.32, other than:

(i) By an instrument payable to the consumer or jointly to the consumer and the contractor; or

(ii) At the election of the consumer, through a third-party escrow agent in accordance with terms established in a written agreement signed by the consumer, the creditor, and the contractor prior to the disbursement.

(2) Notice to assignee. Sell or otherwise assign a mortgage subject to § 226.32 without furnishing the following statement to the purchaser or assignee: "Notice: This is a mortgage subject to special rules under the federal Truth in Lending Act. Purchasers or assignees of this

mortgage could be liable for all claims and defenses with respect to the mortgage that the borrower could assert against the creditor.”

(3) Refinancings within one-year period. Within one year of having extended credit subject to § 226.32, refinance any loan subject to § 226.32 to the same borrower into another loan subject to § 226.32, unless the refinancing is in the borrower’s interest. An assignee holding or servicing an extension of mortgage credit subject to § 226.32, shall not, for the remainder of the one-year period following the date of origination of the credit, refinance any loan subject to § 226.32 to the same borrower into another loan subject to § 226.32, unless the refinancing is in the borrower’s interest. A creditor (or assignee) is prohibited from engaging in acts or practices to evade this provision, including a pattern or practice of arranging for the refinancing of its own loans by affiliated or unaffiliated creditors, or modifying a loan agreement (whether or not the existing loan is satisfied and replaced by the new loan) and charging a fee.

(4) Repayment ability. Engage in a pattern or practice of extending credit subject to § 226.32 to a consumer based on the consumer’s collateral without regard to the consumer’s repayment ability, including the consumer’s current and expected income, current obligations, and employment. There is a presumption that a creditor has violated this paragraph if the creditor engages in a pattern or practice of making loans subject to § 226.32 without verifying and documenting consumers’ repayment ability.

(b) Prohibited acts or practices for dwelling-secured loans; open-end credit. In connection with credit secured by the consumer’s dwelling that does not meet the definition in § 226.2(a)(20), a creditor shall not structure a home-secured loan as an open-end plan to evade the requirements of § 226.32.

6. Appendix H to Part 226 is amended by revising Model Form H-16.

## APPENDIX H TO PART 226—CLOSED-END MODEL FORMS AND CLAUSES

\* \* \* \* \*

## H-16—Mortgage Sample

**You are not required to complete this agreement merely because you have received these disclosures or have signed a loan application.**

**If you obtain this loan, the lender will have a mortgage on your home.**

**YOU COULD LOSE YOUR HOME, AND ANY MONEY YOU HAVE PUT INTO IT, IF YOU DO NOT MEET YOUR OBLIGATIONS UNDER THE LOAN.**

You are borrowing \$\_\_\_\_\_ (optional credit insurance is  is not  included in this amount).

The annual percentage rate on your loan will be: \_\_\_\_\_%.

Your regular [frequency] payment will be: \$\_\_\_\_\_.  
[At the end of your loan, you will still owe us: \$[balloon amount].]

[Your interest rate may increase. Increases in the interest rate could increase your payment. The highest amount your payment could increase is to \$\_\_\_\_\_.]

\* \* \* \* \*

7. In Supplement I to Part 226, the following amendments are made:

- a. Under Section 226.31—General Rules, under Paragraph 31(c)(1)(i), paragraph 2. is added;
- b. Under Section 226.32—Requirements for Certain Closed-End Home Mortgages, under Paragraph 32(a)(1)(ii), paragraph 1. introductory text is revised and 1.iv. is added;
- c. Under Section 226.32—Requirements for Certain Closed-End Home Mortgages, a new heading Paragraph 32(b)(1)(iv) is added and a new paragraph 1. is added;

d. Under Section 226.32—Requirements for Certain Closed-End Home Mortgages, under Paragraph 32(c)(3), the heading is revised, paragraph 1. is revised and paragraph 2. is removed; and a new heading Paragraph 32(c)(5) is added and a new paragraph 1. is added.

e. Under Section 226.32—Requirements for Certain Closed-End Home Mortgages, a new heading Paragraph 32(d)(8) is added; a new heading Paragraph 32(d)(8)(ii) is added and a new paragraph 1. is added; and a new heading Paragraph 32(d)(8)(iii) is added and new paragraphs 1. and 2. are added.

f. Under Section 226.32—Requirements for Certain Closed-End Home Mortgages, 32(e) Prohibited Acts and Practices is removed;

g. A new Section 226.34—Prohibited Acts or Practices in Connection with Credit Secured by a Consumer’s Dwelling; Open-end Credit is added; and

h. Under Appendix H—Closed-End Model Forms and Clauses, paragraphs 20. through 23. are redesignated as paragraphs 21. through 24., and new paragraph 20. is added.

Supplement I to Part 226 — Official Staff Interpretations

\* \* \* \* \*

## SUBPART E—SPECIAL RULES FOR CERTAIN HOME MORTGAGE TRANSACTIONS

### Section 226.31 — General Rules

\* \* \* \* \*

#### 31(c) Timing of disclosure.

\* \* \* \* \*

#### Paragraph 31(c)(1)(i) Change in terms.

\* \* \* \* \*

2. Sale of optional products at consummation. If the consumer finances the purchase of optional products such as credit insurance and as a result the monthly payment differs from what

was previously disclosed under § 226.32, redisclosure is required and a new three-day waiting period applies. (See comment 32(c)(3)-1 on when optional items may be included in the regular payment disclosure.)

\* \* \* \* \*

Section 226.32 — Requirements for Certain Closed-End Home Mortgages

32(a) Coverage.

\* \* \* \* \*

Paragraph 32(a)(1)(ii).

1. Total loan amount. For purposes of the “points and fees” test, the total loan amount is calculated by taking the amount financed, as determined according to § 226.18(b), and deducting any cost listed in § 226.32(b)(1)(iii) and § 226.32(b)(1)(iv) that is both included as points and fees under § 226.32(b)(1) and financed by the creditor. Some examples follow, each using a \$10,000 amount borrowed, a \$300 appraisal fee, and \$400 in points. A \$500 premium for optional credit life insurance is used in one example.

\* \* \* \* \*

iv. If the consumer finances a \$300 fee for a creditor-conducted appraisal and a \$500 single premium for optional credit life insurance, and pays \$400 in points at closing, the amount financed under § 226.18(b) is \$10,400 (\$10,000, plus the \$300 appraisal fee that is paid to and financed by the creditor, plus the \$500 insurance premium that is financed by the creditor, less \$400 in prepaid finance charges). The \$300 appraisal fee paid to the creditor is added to other points and fees under § 226.32(b)(1)(iii), and the \$500 insurance premium is added under 226.32(b)(1)(iv). The \$300 and \$500 costs are deducted from the amount financed (\$10,400) to derive a total loan amount of \$9,600.

\* \* \* \* \*

32(b) Definitions.

\* \* \* \* \*

Paragraph 32(b)(1)(iv).

1. Premium amount. In determining “points and fees” for purposes of this section, premiums paid at or before closing for credit insurance are included whether they are paid in cash or financed, and whether the amount represents the entire premium for the coverage or an initial payment.

\* \* \* \* \*

32(c) Disclosures.

\* \* \* \* \*

Paragraph 32(c)(3) Regular payment; balloon payment.

1. General. The regular payment is the amount due from the borrower at regular intervals, such as monthly, bimonthly, quarterly, or annually. There must be at least two payments, and the payments must be in an amount and at such intervals that they fully amortize the amount owed. In disclosing the regular payment, creditors may rely on the rules set forth in § 226.18(g); however, the amounts for voluntary items, such as credit life insurance, may be included in the regular payment disclosure only if the consumer has previously agreed to the amounts.

\* \* \* \* \*

Paragraph 32(c)(5) Amount borrowed.

1. Optional insurance; debt-cancellation coverage. This disclosure is required when the amount borrowed in a refinancing includes premiums or other charges for credit life, accident, health, or loss-of-income insurance, or debt-cancellation coverage (whether or not the debt-cancellation coverage is insurance under applicable law) that provides for cancellation of all or part of the consumer’s liability in the event of the loss of life, health, or income or in the case of

accident. See comment 4(d)(3)-2 and comment app. G and H-2 regarding terminology for debt-cancellation coverage.

\* \* \* \* \*

32(d) Limitations.

\* \* \* \* \*

32(d)(8) Due-on-demand clause.

Paragraph 32(d)(8)(ii).

1. Failure to meet repayment terms. A creditor may terminate a loan and accelerate the balance when the consumer fails to meet the repayment terms provided for in the agreement; a creditor may do so, however, only if the consumer actually fails to make payments. For example, a creditor may not terminate and accelerate if the consumer, in error, sends a payment to the wrong location, such as a branch rather than the main office of the creditor. If a consumer files for or is placed in bankruptcy, the creditor may terminate and accelerate under this provision if the consumer fails to meet the repayment terms of the agreement. Section 226.32(d)(8)(ii) does not override any state or other law that requires a creditor to notify a borrower of a right to cure, or otherwise places a duty on the creditor before it can terminate a loan and accelerate the balance.

Paragraph 32(d)(8)(iii).

1. Impairment of security. A creditor may terminate a loan and accelerate the balance if the consumer's action or inaction adversely affects the creditor's security for the loan, or any right of the creditor in that security. Action or inaction by third parties does not, in itself, permit the creditor to terminate and accelerate.

2. Examples. i. A creditor may terminate and accelerate, for example, if:

A. The consumer transfers title to the property or sells the property without the permission of the creditor.

- B. The consumer fails to maintain required insurance on the dwelling.
- C. The consumer fails to pay taxes on the property.
- D. The consumer permits the filing of a lien senior to that held by the creditor.
- E. The sole consumer obligated on the credit dies.
- F. The property is taken through eminent domain.
- G. A prior lienholder forecloses.

ii. By contrast, the filing of a judgment against the consumer would permit termination and acceleration only if the amount of the judgment and collateral subject to the judgment is such that the creditor's security is adversely affected. If the consumer commits waste or otherwise destructively uses or fails to maintain the property such that the action adversely affects the security, the loan may be terminated and the balance accelerated. Illegal use of the property by the consumer would permit termination and acceleration if it subjects the property to seizure. If one of two consumers obligated on a loan dies, the creditor may terminate the loan and accelerate the balance if the security is adversely affected. If the consumer moves out of the dwelling that secures the loan and that action adversely affects the security, the creditor may terminate a loan and accelerate the balance.

\* \* \* \* \*

Section 226.34 — Prohibited Acts or Practices in Connection with Credit Secured by a Consumer's Dwelling

34(a) Prohibited acts or practices for loans subject to § 226.32.

Paragraph 34(a)(1) Home-improvement contracts.

Paragraph 34(a)(1)(i).

1. Joint payees. If a creditor pays a contractor with an instrument jointly payable to the contractor and the consumer, the instrument must name as payee each consumer who is primarily obligated on the note.

Paragraph 34(a)(2) Notice to Assignee.

1. Subsequent sellers or assignors. Any person, whether or not the original creditor, that sells or assigns a mortgage subject to § 226.32 must furnish the notice of potential liability to the purchaser or assignee.

2. Format. While the notice of potential liability need not be in any particular format, the notice must be prominent. Placing it on the face of the note, such as with a stamp, is one means of satisfying the prominence requirement.

3. Assignee liability. Pursuant to section 131(d) of the act, the act's general holder-in-due course protections do not apply to purchasers and assignees of loans covered by § 226.32. For such loans, liability for all claims and defenses that the consumer could assert against the creditor is not limited to violations of the act.

Paragraph 34(a)(3) Refinancings within one-year period.

1. In the borrower's interest. The determination of whether or not a refinancing covered by § 226.34(a)(3) is in the borrower's interest is based on the totality of the circumstances, at the time the credit is extended. A written statement by the borrower that "this loan is in my interest" alone does not meet this standard.

i. A refinancing would be in the borrower's interest if needed to meet the borrower's "bona fide personal financial emergency" (see generally § 226.23(e) and § 226.31(c)(1)(iii)).

ii. In connection with a refinancing that provides additional funds to the borrower, in determining whether a loan is in the borrower's interest consideration should be given to whether

the loan fees and charges are commensurate with the amount of new funds advanced, and the real estate-related charges are bona fide and reasonable in amount (see generally § 226.4(c)(7)).

2. Application of the one-year refinancing prohibition to creditors and assignees. The prohibition in section 226.34(a)(3) applies where an extension of credit subject to § 226.32 is refinanced into another loan subject to § 226.32. The prohibition is illustrated by the following examples. Assume that Creditor A makes a loan subject to § 226.32 on January 15, 2003, secured by a first lien; this loan is assigned to Creditor B on February 15, 2003:

i. Creditor A is prohibited from refinancing the January 2003 loan (or any other loan subject to § 226.32 to the same borrower) into a loan subject to § 226.32, until January 15, 2004. Creditor B is restricted until January 15, 2004, or such date prior to January 15, 2004 that Creditor B ceases to hold or service the loan. During the prohibition period, Creditors A and B may make a subordinate lien loan that does not refinance a loan subject to § 226.32. Assume that on April 1, 2003, Creditor A makes but does not assign a subordinate-lien loan subject to § 226.32. In that case, Creditor A would be prohibited from refinancing either the first-lien or subordinate-lien loans (or any other loans to that borrower subject to § 226.32) into another loan subject to § 226.32 until April 1, 2004.

ii. The loan made by Creditor A on January 15, 2003 (and assigned to Creditor B) may be refinanced by Creditor C at any time. If Creditor C refinances this loan on March 1, 2003 into a new loan subject to § 226.32, Creditor A remains prohibited from refinancing any loan subject to § 226.32 to the same borrower into another loan subject to § 226.32 until January 15, 2004. Creditor C is similarly prohibited from refinancing any loan subject to § 226.32 to that borrower into another until March 1, 2004. (The limitations of § 226.34(a)(3) no longer apply to Creditor B after Creditor C refinanced the January 2003 loan and Creditor B ceased to hold or service the loan.)

Paragraph 34(a)(4) Repayment ability.

1. Determining repayment ability. The creditor must consider the consumer's current and expected income, current obligations, and employment. Any expected income can be considered by the creditor, except equity income that the consumer would obtain through the foreclosure of the consumer's principal dwelling. For example, a creditor may use information about income other than regular salary or wages such as gifts, expected retirement payments, or income from self-employment, such as housecleaning or childcare.

2. Pattern or practice of extending credit—repayment ability. Whether a creditor is engaging or has engaged in a pattern or practice of violations of this section depends on the totality of the circumstances in the particular case. While a pattern or practice is not established by isolated, random, or accidental acts, it can be established without the use of a statistical process. In addition, a creditor might act under a lending policy (whether written or unwritten) and that action alone could establish that there is a pattern or practice of making loans in violation of this section.

3. Discounted introductory rates. In transactions where the creditor sets an initial interest rate to be adjusted later (whether fixed or to be determined by an index or formula), in determining repayment ability the creditor must consider the consumer's ability to make loan payments based on the non-discounted or fully-indexed rate at the time of consummation.

4. Verifying and documenting income and obligations. Creditors may verify and document a consumer's repayment ability in various ways. A creditor may verify and document a consumer's income and current obligations through any reliable source that provides the creditor with a reasonable basis for believing that there are sufficient funds to support the loan. Reliable sources include, but are not limited to, a credit report, tax returns, pension statements, and payment records for employment income.

\* \* \* \* \*

Paragraph 34(b) Prohibited acts or practices for dwelling-secured loans; open-end credit.

1. Amount of credit extended. Where a loan is documented as open-end credit but the features and terms or other circumstances demonstrate that it does not meet the definition of open-end credit, the loan is subject to the rules for closed-end credit, including § 226.32 if the rate or fee trigger is met. In applying the triggers under § 226.32, the “amount financed,” including the “principal loan amount” must be determined. In making the determination, the amount of credit that would have been extended if the loan had been documented as a closed-end loan is a factual determination to be made in each case. Factors to be considered include the amount of money the consumer originally requested, the amount of the first advance or the highest outstanding balance, or the amount of the credit line. The full amount of the credit line is considered only to the extent that it is reasonable to expect that the consumer might use the full amount of credit.

APPENDIX H — CLOSED-END MODEL FORMS AND CLAUSES

\* \* \* \* \*

20. Sample H-16. This sample illustrates the disclosures required under § 226.32(c). The sample illustrates the amount borrowed and the disclosures about optional insurance that are required for mortgage refinancings under § 226.32(c)(5). Creditors may, at their option, include these disclosures for all loans subject to § 226.32. The sample also includes disclosures required under § 226.32(c)(3) when the legal obligation includes a balloon payment.

\* \* \* \* \*

By order of the Board of Governors of the Federal Reserve System, December \*\*, 2001.

Jennifer J. Johnson  
Secretary of the Board  
BILLING CODE 6210-01-P