BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

DATE:	July 8, 2008
TO:	Board of Governors
FROM:	Division of Consumer and Community Affairs *
SUBJECT:	Amendments to Regulation Z (Truth in Lending) and Regulation C (Home Mortgage Disclosure)

ACTION REQUESTED: Approval to publish final amendments to Regulation Z (Truth in Lending) and proposed amendments to Regulation C (Home Mortgage Disclosure). The final amendments to Regulation Z prohibit certain acts and practices in connection with closed-end mortgage loans, particularly higher-priced mortgage loans; revise the disclosure requirements for mortgage advertisements; and revise the timing requirements for providing disclosures for closed-end mortgages. The proposed amendments to Regulation C would make rules for reporting higher-priced loans consistent with the Regulation Z amendments.

Summary

Under the Home Ownership and Equity Protection Act (HOEPA), which amended the Truth in Lending Act (TILA), the Board is authorized to prohibit acts and practices in connection with mortgage lending that the Board finds to be unfair, deceptive, or designed to evade HOEPA and, with respect to mortgage refinancings, associated with abusive lending practices, or otherwise not in the interest of the borrower. The amendments to Regulation Z rely upon this authority, along with the Board's general rulemaking authority, to achieve four goals: (1) prohibit certain acts or practices for higher-priced mortgage loans and loans that meet HOEPA's cost triggers; (2) prohibit other acts or practices for all closed-end credit transactions secured by a consumer's principal dwelling; (3) revise the disclosures required in advertisements for credit secured

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by a consumer's dwelling and prohibit certain practices in connection with closed-end mortgage advertising; and (4) require disclosures for closed-end mortgages secured by a consumer's principal dwelling to be provided earlier in the transaction.

Truth in Lending Act Rules

First, staff recommends amending Regulation Z with regard to higher-priced mortgage loans and HOEPA-covered loans that are secured by a consumer's principal dwelling to prohibit creditors from: (1) extending credit based on the collateral without regard to consumers' ability to repay; (2) making a loan without verifying the income and assets relied upon to determine repayment ability; and (3) imposing prepayment penalties in certain circumstances. Staff also recommends amending Regulation Z to prohibit creditors from (4) making higher-priced first-lien mortgage loans without establishing escrows for taxes and insurance. In addition, the final rule prohibits creditors from structuring higher-priced mortgage loans as open-end lines of credit to evade the new protections.

As discussed in detail beginning on page 15, the term "higher-priced mortgage loans" is defined as closed-end consumer credit transactions secured by the consumer's principal dwelling where the annual percentage rate (APR) on the loan exceeds the average offer rate on prime loans published by the Board by at least 1.50 percentage points for first-lien loans, or 3.50 percentage points for subordinate-lien loans. A summary of the specific staff recommendations regarding higher-priced mortgages follows:

- Ability to Pay. The final rule prohibits a creditor from extending a higher-priced loan, including a HOEPA-covered loan, secured by the consumer's principal dwelling based on the collateral and without regard to the consumer's repayment ability. A presumption of compliance for following certain underwriting procedures is provided. The final rule is discussed in detail beginning on page 20.

- Verification of Income and Assets. The final rule prohibits creditors, in extending credit for a higher-priced mortgage or a HOEPA-covered loan secured by a consumer's principal dwelling, from relying on amounts of income (including expected income) or assets to assess repayment ability, unless the creditor verifies such amounts by third-party documents that provide reasonably reliable evidence of the consumer's income and assets. The final rule provides a defense for creditors who fail to verify income or assets before extending credit, in cases where the consumer's income or assets upon which the creditor relied were not materially greater than what the creditor could have verified at closing. The final rule is discussed in detail beginning on page 27.

- Prepayment Penalties. The final rule prohibits creditors from imposing a penalty for prepayment of a higher-priced loan or HOEPA-covered loan secured by the consumer's principal dwelling if the payment can change in the first four years of the loan's term. For other higher-priced loans and HOEPA-covered loans, the rule restricts prepayment penalties to the first two years of the loan's term, and imposes other limitations. The final rule is discussed in detail beginning on page 29.

- Escrows. The final rule prohibits a creditor from making a higher-priced loan secured by a first-lien on a consumer's principal dwelling without establishing an escrow account for property taxes and homeowners' insurance. A creditor is permitted, but not required, to offer the borrower the opportunity to cancel the escrow twelve months after consummation. The final rule is discussed in detail beginning on page 38.

Second, staff recommends amending Regulation Z with regard to all closed-end credit transactions secured by a consumer's principal dwelling to prohibit: (1) creditors or mortgage brokers from coercing appraisers to misrepresent the value of a dwelling; and (2) loan servicers from engaging in certain unfair loan servicing practices. Staff also recommends withdrawing the proposal that would have prohibited creditors from paying mortgage brokers, unless certain disclosures have been provided by the broker in a timely fashion to the consumer. A summary of the specific staff recommendations follows:

- Coercion of Appraisers. The final rule prohibits a creditor or mortgage broker from coercing, influencing, or encouraging an appraiser to misrepresent the value of a consumer's principal dwelling. The rule also prohibits creditors from extending credit when a creditor knows that a person has coerced, influenced, or encouraged an appraiser to misstate the value of a consumer's principal dwelling, unless the creditor acts with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of such dwelling. The final rule is discussed in detail beginning on page 43.

- Loan Servicing. The final rule prohibits certain practices by servicers in connection with consumer credit transactions secured by a consumer's principal dwelling. The rule prohibits a servicer from failing to credit a payment to the consumer's account as of the date of receipt or failing to provide a payoff statement within a reasonable period of time after the request. The final rule also prohibits the practice of "pyramiding" late fees. The final rule is discussed in detail beginning on page 47.

- Yield Spread Premiums (Mortgage Broker Compensation). The proposal generally would have prohibited creditors from directly or indirectly paying mortgage brokers in connection with consumer credit transactions secured by a consumer's principal dwelling, unless the mortgage broker entered into a written agreement with the consumer specifying the total dollar amount of the broker's compensation. The staff recommends withdrawal because consumer testing revealed that the disclosure may confuse consumers. Moreover, creditors sometimes act as brokers, as brokers sometimes act as creditors, and in those cases disclosures would be inaccurate. The reasons for this recommendation are discussed in detail beginning on page 51.

Third, staff recommends amending Regulation Z to revise the advertising rules for credit secured by a consumer's dwelling so that consumers receive accurate and balanced information. A summary of the specific staff recommendations follows:

- Prohibited Advertising Practices. The final rule adopts the proposal to prohibit seven misleading or deceptive practices in advertisements for closed-end mortgages. For example, the final rule prohibits use of the term "fixed" in a misleading manner in advertisements where the rate or payment is not fixed for the full term of the loan.

- Advertising Disclosures. The final rule, like the proposal, requires that advertisements state all applicable rates or payments with equal prominence and in close proximity to any advertised promotional or "teaser" rate or payment. The final advertising rules are discussed in detail beginning on page 54.

Fourth, staff recommends amending Regulation Z to require creditors to provide early disclosures to consumers for all closed-end mortgage transactions secured by the consumer's principal dwelling. The current rule requires early disclosures only in connection with closed end loans to purchase a home. The final rule requires early disclosures for closed-end loans to refinance an existing loan and for closed-end home equity loans as well. The final rule also prohibits a creditor or other person from imposing a fee on the consumer in connection with the consumer's application for a closed-end mortgage transaction (other than a reasonable fee to obtain a credit report or other credit history) until after the consumer has received the early disclosures. The final rule is discussed in detail beginning on page 59.

Effective dates. Staff recommends making the revisions to Regulation Z effective on October 1, 2009, except for the escrow rules. Staff recommends that the requirement to escrow for first-lien higher priced loans and HOEPA-covered loans take effect on April 1, 2010; but for such loans secured by manufactured homes, on October 1, 2010.

Home Mortgage Disclosure Act Rules

Staff recommends publishing for comment revisions to the rules implementing the Home Mortgage Disclosure Act (Regulation C), to revise the existing rules for reporting loan pricing on higher-priced loans so as to be consistent with the Regulation Z definition of "higher-priced" loans. Revising Regulation C to conform to Regulation Z would reduce regulatory burden and improve the quality of HMDA data. Staff also recommends requiring public comment by August 29, 2008, which is likely to result in a comment period of between 35 and 45 days, notwithstanding the Board's usual policy of providing comment periods of at least 60 days in its proposed rules. This recommendation is based on the need for coordination of effective dates between the final rule under Regulation Z and the proposal under Regulation C, the priority of making Regulation C amendments final as of January 1 of a given year (because of the calendar-year HMDA reporting scheme), and the resulting exigencies of implementing the Regulation C changes. The Regulation C recommendation is discussed in more detail beginning on page 19.

Background

Recent Problems in the Mortgage Market

The mortgage market is often characterized as having three segments: the prime market; the subprime market; and the near-prime or alt-A market. In the prime market, competitive, widely-quoted rates and other terms are offered to consumers believed to pose a low credit risk. In the subprime market, consumers believed to pose a higher credit risk may obtain mortgages at rates and on terms less favorable than the rates and terms available in the prime market. The near-prime or alt-A market falls between the prime and subprime markets.

In recent years, a substantial majority of subprime mortgage loans have been adjustable rate mortgages (ARMs) with two or three-year introductory “teaser” rates that are followed by substantial increases in the rate and payment. Within the last two years, delinquencies for such mortgages have increased dramatically and reached exceptionally high levels. The delinquency rate for subprime mortgages may rise further as the rates on large numbers of subprime ARMs reset at significantly higher levels. The delinquency rate has also increased for near-prime or alt-A loans, but not as dramatically as it has for subprime mortgages. Consumers who default on home mortgage obligations face potentially severe consequences, including foreclosure and loss of the home, loss of accumulated home equity, higher rates for other credit, and reduced access to credit.

In addition to the general decline in real estate values, a loosening of underwriting standards has contributed to the recent increase in subprime mortgage delinquencies. A loosening of underwriting standards is particularly evident in the subprime mortgage market where insufficient regard to repayment ability, the lack of income verification, and high loan-to-value ratios combine to increase the risk of default. Looser underwriting standards have not been limited to the subprime market, but have also occurred in the alt-A market where risk layering on nontraditional mortgages, such as interest-only mortgages and payment-option ARMs, has been common.

Structural factors in the subprime market warrant regulatory intervention to prevent injury to consumers. The role that these structural factors play in increasing the likelihood of injury to consumers has been highlighted by the recent increase in delinquencies among subprime mortgages.

First, there is limited transparency in the subprime mortgage market, which makes it harder for consumers to protect themselves from abusive or unaffordable loans. Price information for the subprime market is not widely and readily available to consumers. This may limit consumer shopping. In addition, products in the subprime market, such as ARMs, tend to be complex. As a result, consumers may focus on a few key attributes, such as the initial interest rate and down payment, but not focus on other important attributes, such as the possibility of subsequent rate or payment increases. In addition, the roles and incentives of originators are not clear to consumers. Consumers often believe, usually in error, that a mortgage broker is obligated to find the consumer the best and most suitable loan terms available.

Second, the market structure in which most subprime loans have been securitized and sold to investors gives originators an incentive to generate high loan sales volume, rather than to underwrite loans carefully to ensure loan quality. Fragmentation of the mortgage originator market makes it difficult for regulators and investors to monitor originator activities.

The market is responding to the current problems with subprime mortgages by tightening underwriting standards and through other actions. However, staff believes structural factors in the subprime mortgage market make it appropriate to issue regulations to help prevent a recurrence of these problems and to provide clear rules at a time of uncertainty so that responsible subprime mortgage lending can take place.

<u>The Truth in Lending Act</u>

Congress enacted TILA based on findings that economic stability would be enhanced and competition among consumer credit providers would be strengthened by the informed use of credit resulting from consumers' awareness of the cost of credit. One of the stated purposes of TILA is to provide a meaningful disclosure of credit terms to enable consumers to compare credit terms available in the marketplace more readily and avoid the uninformed use of credit. TILA's disclosure requirements differ depending on whether consumer credit is an open-end (revolving) plan or a closed-end (installment) loan. TILA also contains procedural and substantive protections for consumers.

Congress enacted HOEPA in 1994 as an amendment to TILA. HOEPA imposed additional substantive protections on certain high-cost mortgage transactions. HOEPA-covered loans are closed-end, non-purchase money mortgages secured by a consumer's principal dwelling (other than a reverse mortgage) where either: (a) the APR at consummation will exceed the yield on Treasury securities of comparable maturity by more than 8 percentage points for first-lien loans, or 10 percentage points for subordinate-lien loans; or (b) the total points and fees payable by the consumer at or before closing exceed the greater of 8 percent of the total loan amount, or $547 for 2007 (adjusted annually).

HOEPA also authorized the Board to prohibit acts or practices in connection with mortgage loans and the refinancing of mortgage loans. In addition, HOEPA directed the Board to monitor through regular public hearings changes in the home equity market that might require the Board to prohibit acts or practices.

TILA is implemented by the Board's Regulation Z. An Official Staff Commentary interprets the requirements of Regulation Z. By statute, creditors that follow in good faith Board or official staff interpretations are insulated from civil liability, criminal penalties, or administrative sanction. Creditors face civil liability for violations of TILA or Regulation Z, including engaging in acts or practices that the Board has prohibited under its HOEPA authority.

<u>The Board's Rulemaking Authority</u>

TILA Section 129(l)(2), added to the statute by HOEPA, provides the Board with the authority to prohibit acts or practices in connection with:

- Mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of HOEPA; and
- Refinancing of mortgage loans that the Board finds to be associated with abusive lending practices or that are otherwise not in the interest of the borrower.

HOEPA does not create a standard for what is unfair or deceptive, but the Congressional Conference Report for HOEPA indicates that the Board should look to the standards employed for interpreting state unfair or deceptive trade practices acts and the Federal Trade Commission Act.[1] Board staff has considered these standards in developing the final rule.

The Board's authority to prohibit unfair or deceptive acts or practices in connection with mortgage loans is broad and is not limited to mortgage loans currently covered by HOEPA. This authority allows the Board to prohibit acts or practices in connection with mortgage loans that do not meet the rate or fee triggers for HOEPA-covered loans, and in connection with home purchase loans, which are not covered by HOEPA. It also authorizes the Board to strengthen HOEPA's restrictions and prohibitions on certain loan terms and practices, for HOEPA-covered loans and for other mortgage loans. Moreover, the prohibitions adopted pursuant to this authority need not apply solely to creditors, nor be limited to the terms of mortgage loans. The prohibitions may apply to acts or practices by various parties "in connection with mortgage loans." Accordingly, the revisions apply new prohibitions to a broader segment of the market than that which is currently covered by HOEPA's substantive protections. The final rule also strengthens restrictions that apply to HOEPA-covered loans, including a prohibition of prepayment penalties in certain circumstances. The Board's HOEPA rulemaking authority provides the legal basis for the prohibitions in proposed sections 226.35 and 226.36, as well as the proposed prohibitions on misleading advertising practices.

[1] H. Conf. Rep. 103-652, p. 162 (1994).

In addition, TILA's general rulemaking authority specifically authorizes the Board, among other things, to do the following:

- Issue regulations implementing TILA to carry out its purposes.

- Except for HOEPA-covered loans, issue rules that contain such classifications, differentiations, or other provisions, or that provide for such adjustments and exceptions for any class of transactions, that in the Board's judgment are necessary or proper to effectuate the purposes of TILA, facilitate compliance with the act, or prevent circumvention or evasion.

- Exempt from all or part of TILA any class of transactions, except for HOEPA-covered loans, if the Board determines that TILA coverage does not provide a meaningful benefit to consumers in the form of useful information or protection. The Board must consider factors identified in the act and publish its rationale at the time it proposes an exemption for comment.

- Require disclosures in advertisements for closed-end credit and open-end credit plans.

The Board's general rulemaking authority under TILA provides the legal basis for the revisions to Regulation Z regarding the timing of mortgage disclosures and advertising disclosures.

The Board's Proposal

On January 9, 2008, the Board published for comment proposed rules that would amend Regulation Z. The proposal was developed based on extensive outreach, including consultation with the Board's Consumer Advisory Council in 2006 and 2007. In addition, the Board held four public hearings across the country in the summer of 2006, and a fifth hearing in Washington, D.C. in June 2007. Hearing panelists included interested parties such as creditors, mortgage brokers, credit ratings agencies, community development groups, consumer advocates, researchers, and state and federal officials. Panelists at the 2006 hearings discussed concerns about mortgage lending and impact of state and Federal laws on mortgage credit, including subprime credit. At the June 2007 hearing, panelists focused on whether and how the Board might use its rulemaking authority to address four areas of concern: lenders' determination of borrowers' repayment ability; stated income or "no doc" lending; the lack of escrows in the subprime market; and the high frequency of prepayment penalties in the subprime market. In addition to testimony at the hearings, the Board also solicited public comment on these issues and received over 100 letters.

The January 2008 proposal would have imposed the following rules on "higher-priced" mortgage loans:

- Prohibit a creditor from engaging in a pattern or practice of making higher-priced mortgage loans or HOEPA-covered loans based on the collateral and without regard to the borrower's ability to repay;

- Require a creditor to verify the income or assets relied upon in making higher-priced or HOEPA-covered loans;

- Require a creditor to establish for first-lien higher-priced loans an escrow account for taxes and insurance;

- Restrict the conditions under which prepayment penalties could be imposed on higher-priced loans or HOEPA-covered loans.

For loans secured by a consumer's principal dwelling, the Board proposed to:

- Prohibit a creditor from paying a mortgage broker more than the consumer had agreed the broker would receive;

- Prohibit a creditor or mortgage broker from coercing an appraiser to misstate a dwelling's value; and

- Prohibit four unfair servicing practices, including failing to promptly credit payments received.

The proposed rule also would have revised the disclosure requirements for mortgage advertisements, and revised the timing of mortgage disclosures.

Public Comments on the Board's Proposal

The Board received approximately 4,700 comments on the proposal. The comments came from community banks, large bank holding companies, secondary market participants, credit unions, state and national trade associations for financial institutions in the mortgage business, mortgage brokers and mortgage broker trade associations, realtors and realtor trade associations, individual consumers, local and national community groups, federal and state regulators and elected officials, appraisers, academics, and other professionals.

Commenters generally supported the Board's effort to protect consumers from unfair practices while preserving responsible lending and sustainable homeownership. However, industry commenters favored narrower coverage for "higher-priced mortgage loans" and relaxed restrictions. They also expressed concerns about the increased costs of certain provisions, such as the requirement to establish escrows for all higher-priced loans. Consumer advocates and federal and state regulators (including the Federal Deposit Insurance Corporation (FDIC)) and some elected officials (including members of Congress and some state attorneys general) supported the proposal as addressing some of the abuses in the subprime market, but argued that additional consumer protections are needed.

Commenters also discussed the Board's rulemaking authority. Industry commenters urged the Board to adopt the rules under its TILA Section 105(a) authority rather than its HOEPA UDAP authority. They argued that HOEPA UDAP authority would impose substantial and disproportionate penalties on lenders for violations and unnecessary costs on consumers. Consumer advocates, on the other hand, supported use of the Board's HOEPA UDAP authority and urged the Board to expand its use of that authority for the early TILA disclosures and all of the advertising restrictions. Industry and some consumer advocates also stated that with regard to any new mortgage disclosures, the Board should coordinate with the Department of Housing and Urban Development (HUD) to ensure that such disclosures are consistent with disclosures required under the Real Estate Settlement Procedures Act (RESPA).

Public comments with respect to specific provisions of the proposal are described and discussed in more detail below.

Discussion

A. <u>Scope of Mortgage Loans Covered by the Final Rule</u>

<u>Summary of Final Revisions</u>

The rule applies the following consumer protections to a subset of consumer mortgage loans, referred to as "higher-priced mortgage loans," and HOEPA-covered loans:

- The prohibition on creditors' making any higher-priced mortgage loan or a HOEPA-covered loan based on the collateral without regard to consumers' repayment ability;
- The prohibition on creditors' making a higher-priced mortgage loan or a HOEPA-covered loan without verifying by third-party documents the consumer income and assets the creditor relied upon to make the loan;
- The prohibition on prepayment penalties except under certain conditions.

The final rule applies the requirement to establish an escrow account for property taxes and homeowners' insurance for first-lien higher-priced mortgage loans and first-lien HOEPA-covered loans. In addition, the revisions prohibit structuring a loan as an open-end line of credit to evade the new protections for higher-priced mortgage loans.

The other consumer protections contained in the final rule, such as the prohibition on coercion of appraisers, and misleading advertisements, apply to broader segments of the mortgage market.

Definition of "Higher-Priced Mortgage Loan"

Proposed and final rules. The Board proposed to define higher-priced mortgage loans as consumer credit transactions secured by the consumer's principal dwelling for which the APR on the loan exceeds the yield on comparable Treasury securities by at least three percentage points for first-lien loans, or five percentage points for subordinate-lien loans. The proposed definition would include home purchase loans, refinancings, and home equity loans. The definition would have excluded home equity lines of credit ("HELOCs"). There would also have been exclusions for reverse mortgages, construction-only loans, and bridge loans.

The final rule adopts a definition of "higher-priced mortgage loan" that is similar in concept to that proposed but different in the index and hence the thresholds used. Instead of yields on Treasury securities, the definition uses a survey-based estimate of rates for the lowest-risk prime mortgages, referred to as the "average prime offer rate." The survey staff would use to estimate these rates is the Primary Mortgage Market Survey® (PMMS) conducted by Freddie Mac. The PMMS contains weekly average rates and points offered by a representative sample of creditors to prime borrowers seeking a first-lien, conventional, conforming mortgage and who would have at least 20 percent equity. As the PMMS is limited to four product types, staff will have to estimate rates for other product types. The staff has developed a method for these estimations that it recommends the Board seek comment on, at the same time that the Board seeks comment on the proposal to amend the HMDA regulations, as discussed below. Under the final rule a transaction is a higher-priced loan if its APR exceeds the average prime offer rate on a comparable transaction by 1.5 percentage points, or 3.5 percentage points in the case of a subordinate-lien transaction.

Public Comments on the Proposed Rule

Most industry commenters, a national consumer advocacy and research organization, and others supported the approach of using loan price to identify loans requiring stricter regulations. A large number and wide variety of these commenters, however, urged the Board to use a prime mortgage market rate instead of, or in addition to, Treasury yields to avoid arbitrary changes in coverage due to changes in the risk premium for mortgages over Treasuries or in the relationship between short-term and long-term Treasury yields. Industry commenters were particularly concerned that the threshold over the chosen index be set high enough to exclude the prime market. They maintained that the proposed thresholds of 300 and 500 basis points over Treasury yields would cover a significant part of the prime market and reduce credit availability.

Consumer and civil rights group commenters generally, but not uniformly, opposed limiting protections to higher-priced mortgage loans and recommended applying these protections to all loans secured by a principal dwelling. They recommended in the alternative that the thresholds be adopted at the levels proposed or even lower and that nontraditional mortgage loans, which permit non-amortization or negative amortization, be covered regardless of loan price.

The proposed exclusion of HELOCs drew criticism from several consumer and civil rights groups but strong support from industry commenters. The other proposed exclusions drew limited comment.

Discussion of the Final Rule

Index. The staff has analyzed the comments and available data, and believes that a mortgage market rate should be used instead of yields on Treasury securities to define higher-priced loans. The spread between yields on Treasury securities and mortgage market rates can change in the short term and in the long term. Changes in the Treasury-mortgage spread can mean that loans with identical credit risk are covered in some periods but not in others, contrary to the rule's goal of consistent and predictable coverage. An index that derives directly from a mortgage market survey would avoid that problem.

The staff believes the Freddie Mac PMMS is currently the best vehicle for obtaining mortgage market rate data for purposes of this rule. This is the only frequently updated publicly available data source that has rates for more than one kind of fixed-rate mortgage (the 15-year and the 30-year) and more than one kind of variable-rate mortgage (the 1-year ARM and the 5/1 ARM). These rates are updated every week and are published on Freddie Mac's web site. Staff would use the PMMS to estimate and publish average prime offer rates, which will be annual percentage rates (not contract rates). The staff will monitor the PMMS over time to ensure it continues to be appropriate for this rule's purposes. If the PMMS ceases to be available, or if circumstances arise that render it unsuitable for this rule, the staff will consider other alternatives including the Board's conducting its own survey.

Thresholds. The final rule adopts a threshold of 1.5 percentage points above the average prime offer rate for a comparable transaction for first-lien loans, and 3.5 percentage points for second-lien loans. Based on available data, it appeared that the proposed thresholds of 3 and 5 percentage points above comparable Treasuries would have captured all of the subprime market and a portion of the alt-A market.[2] Based also on available data, the staff believes that the thresholds it is recommending would cover all, or virtually all, of the subprime market and a portion of the alt-A market. The data the staff considered are loan-level origination data from First American LoanPerformance for the period 2004 to 2007 for subprime and alt-A securitized pools. The staff also ascertained from a proprietary database of mostly-prime loans that coverage of the prime market during the first three-quarters of 2007 at these thresholds would have been very limited. The staff recognizes that the recent mortgage market disruption began at the end of this period, so coverage of prime loans, especially prime jumbo loans, may be significant for a time**.**

The final rule adopts a threshold for subordinate-lien loans of 3.5 percentage points. This is consistent with the Board's proposal to set the threshold over Treasury yields for these loans two percentage points above the threshold for first-lien loans. With rare exceptions, commenters explicitly endorsed, or at least did not raise any objection to,

[2] The Board noted with the proposal that the percentage of the first-lien mortgage market Regulation C has captured as higher-priced using a threshold of three percentage points has been greater than the percentage of the total market originations that one industry source has estimated to be subprime (25 percent vs. 20 percent in 2005; 28 percent vs. 20 percent in 2006). For industry estimates see Inside Mortgage Finance Publications, Inc., The 2007 Mortgage Market Statistical Annual vol. I (IMF 2007 Mortgage Market), at 4. Regulation C is not thought, however, to have reached the prime market. Rather, in both years it reached into the alt-A market, which the same source estimated to be 12 percent in 2005 and 13 percent in 2006. In 2004, Regulation C captured a significantly smaller part of the market than an industry estimate of the subprime market (11 percent vs. 19 percent), but that year's HMDA data were somewhat anomalous because of a steep yield curve.

this approach. Although data are very limited, the staff believes it is appropriate to apply the same difference of two percentage points to the thresholds above market mortgage rates.

Types of loans covered. The final rule extends the protections for higher-priced loans to home purchase and home improvement loans, and refinancings, as proposed. The final rule covers nontraditional mortgage loans only if their APRs exceed the threshold. Staff believes the protections should be extended based on risk as reflected in loan price and not by product type. Covering only certain product types would reduce the rule's predictability, as the Board would have to frequently reexamine the products covered as new products were developed.

The rule also excludes from "higher-priced mortgage loans" HELOCs and certain other types of transactions as proposed. HELOCs are typically held in portfolio and are concentrated in the bank and thrift institutions where the federal banking and thrift agencies can use supervisory guidance and other tools to protect borrowers. Staff recognizes, however, that HELOCs present a risk of circumvention. Thus the final rule, like the proposal, prohibits structuring a closed-end higher-priced loan as an open-end transaction for the purpose of evading the new protections for higher-priced loans.

Proposal to Revise Reporting of Higher-Priced Loans under Regulation C

Staff recommends that the Board propose amendments to Regulation C, which implements the Home Mortgage Disclosure Act (HMDA), to revise the existing rules for reporting loan pricing on higher-priced loans to be consistent with the Regulation Z amendments. Revising Regulation C to conform to Regulation Z would reduce regulatory burden and improve the quality and utility of the HMDA data.

HMDA requires mortgage lenders to collect, report to regulators, and disclose to the public data about their mortgage lending, including loan pricing (rate spread). Lenders must report the difference between a loan's APR and the yield on comparable Treasury securities if that difference is 3 percentage points or more for a first-lien loan, or 5 percentage points or more for a subordinate-lien loan. The rate spread reporting thresholds under HMDA are intended to cover subprime mortgages but not prime mortgages, paralleling the intent of the higher-priced mortgage loan definition recommended to be adopted under Regulation Z.

B. Prohibited Acts and Practices in Connection with Higher-Priced Mortgages

1. Ability to Repay

Summary of Proposed and Final Rules

TILA and Regulation Z prohibit a pattern or practice of extending HOEPA-covered loans based on consumers' collateral without regard to their repayment ability. The regulation creates a presumption of a violation where a creditor has a pattern or practice of failing to verify and document repayment ability. The Board proposed to revise the prohibition on disregarding repayment ability and extend it to higher-priced mortgage loans. The proposed revisions included adding several rebuttable presumptions of violations for a pattern or practice of failing to follow certain underwriting procedures, and a safe harbor.

The final rule removes "pattern or practice" and therefore prohibits any HOEPA-covered loan or higher-priced loan from being extended based on the collateral without regard to repayment ability. Verifying repayment ability has been made a requirement rather than a presumptive requirement, the proposed new presumptions of violations for failing to follow certain underwriting procedures have been removed, and these underwriting procedures have been incorporated in a presumption of compliance.

Comments on proposed rule. Mortgage lenders and their trade associations that commented generally, but not uniformly, supported or at least did not oppose a rule requiring creditors to consider repayment ability. They maintained, however, that the proposed rule would unduly constrain credit availability because of the combination of potentially significant damages and a perceived lack of a clear and flexible safe harbor. On the other hand, consumer, civil rights, and community development groups, as well as some federal, state and local government officials, several members of Congress, and others maintained that "pattern or practice" would effectively prevent a borrower from bringing a claim or counter-claim based on his loan alone, and reduce the rule's deterrence of irresponsible lending.

Unfairness Analysis Under the FTC Act Standards

The staff believes that making higher-priced loans and HOEPA-covered loans without regard to the borrower's ability to repay is unfair under the FTC Act standards. When borrowers cannot afford to repay their loans, they suffer significant injury, such as loss of home equity or other assets, or foreclosure. Entire communities may experience a decline in homeowner equity if unaffordable loans are concentrated in specific neighborhoods, leading to a decline in property values. Some borrowers may not understand that they are entering into unaffordable loans or may not be able to avoid entering into such loans. There does not appear to be any benefit to consumers from loans that are unaffordable at origination or immediately thereafter. There may be some benefit to consumers from loans that are underwritten based on the collateral and without regard to consumers' ability to sustain their payments past some initial period. The staff believes, however, that this rare benefit is outweighed by the substantial costs to most borrowers and communities of extending higher-risk loans without regard to repayment ability. The final rule does, however, contain an exemption for temporary or "bridge" loans of 12 months or less, though this exemption is intended to be construed narrowly.

Discussion of the Final Rule

Pattern or practice. The final rule does not include "pattern or practice" and therefore prohibits any higher-priced loan or HOEPA-covered loan from being extended based on the collateral without regard to repayment ability. The staff believes that removing "pattern or practice" is appropriate to ensure a remedy for consumers who are given unaffordable loans and to deter irresponsible lending, which injures not just individual borrowers but also their neighbors and communities. Moreover, staff believes that individual remedies impose a more immediate and more certain cost on violators than either class actions or actions by state or federal agencies.

In the proposal, the Board was concerned that if every defaulted loan could form the basis of a lawsuit, lenders would shy away from higher-priced lending, reducing credit availability. Concerns over litigation costs are legitimate, but staff believes that several factors – including the one-year statute of limitations on affirmative claims, after which only recoupment and set-off are available; the unavailability of strict assignee liability under TILA for violations of this rule for all but HOEPA-covered loans; the fact that many defaults may be caused by intervening events such as job loss rather than faulty underwriting; and the substantial cost to plaintiffs of proving a claim of faulty underwriting, which would often require substantial discovery and expert witnesses –

would help contain litigation costs for creditors and associated cost increases for consumers. The staff further believes that the recommended presumption of compliance will provide more certainty to creditors than either "pattern or practice" or the proposed safe harbor. The presumption will better aid creditors with compliance planning, and it will better help them mitigate litigation risk.

Presumption of compliance. The final rule removes the proposed presumptions of violations for failing to follow certain underwriting practices and incorporates these practices into the presumption of compliance. Thus the final rule provides that a creditor is presumed to have complied with the ability to repay rule if the creditor satisfies each of three requirements: (1) verifying repayment ability, discussed below; 2) determining the consumer's repayment ability using the fully-indexed rate and fully-amortizing payment, except in certain specified circumstances, and considering other mortgage-related obligations such as property taxes and homeowners insurance; and (3) assessing the consumer's repayment ability using one of the following measures: a ratio of total debt obligations to income, or the income the consumer will have after paying debt obligations.

The creditor's presumption of compliance for satisfying these requirements is not conclusive. The staff believes a conclusive presumption could seriously undermine consumer protection. For example, a creditor could verify repayment ability, use the fully-indexed rate and fully-amortizing payment, and employ a debt-to-income ratio (DTI) – and still disregard repayment ability in a particular case or potentially in many cases. Therefore, under the final rule, the borrower may rebut the presumption with evidence that the creditor disregarded repayment ability despite following these procedures. For example, evidence of a very high debt-to-income ratio and a very limited residual income could be sufficient to rebut the presumption, depending on all of the facts and circumstances.

(i) Fully indexed rate and fully amortizing payment. The final rule specifies the rate and payment creditors must use to obtain the presumption of compliance. On a loan with a variable rate, the rate specified is the fully-indexed rate (the sum of the index value and margin) as of consummation or the initial rate if greater. The creditor may, however, use a discounted initial rate if this rate is fixed for at least seven years. If the loan has a stepped-rate, the rate specified is the highest possible rate in the seven years following consummation. A substantial majority of subprime loans, both fixed-rate and variable-rate, have prepaid (or defaulted) within seven years of origination, according to available data. Prepayment speeds can change over time, but the staff believes that seven years will remain a reasonable horizon for subprime loans given the various reasons that subprime borrowers prepay (e.g., an improved credit score supports a lower interest rate or a cash-strapped borrower needs to tap equity).

The presumption of compliance provision also specifies that the creditor use the fully-amortizing payment, with an exception for interest-only loans where the initial payment is fixed for at least seven years and balloon loans with a term of at least seven years.

(ii) Debt-to-income ratio and residual income. The proposal provided that a creditor would be presumed to have violated the regulation if it engaged in a pattern or practice of failing to consider the ratio of consumers’ total debt obligations to consumers’ income or the income consumers will have after paying debt obligations.

The final rule provides that a creditor does not have a presumption of compliance with respect to a particular transaction unless it uses at least one of the following: the consumer's ratio of total debt obligations to income or the income the consumer will have after paying debt obligations.

The staff believes the flexibility permitted by the final rule will help promote access to responsible credit without weakening consumer protection. The rule provides creditors flexibility to determine whether using both a DTI ratio and residual income increases a creditor's ability to predict repayment ability. If one of these metrics alone holds as much predictive power as the two together, as may be true of certain underwriting models at certain times, then conditioning access to a presumption of compliance on using both metrics could reduce access to credit without an offsetting increase in consumer protection. The staff also took into account that, at this time, residual income may not be as widely used or tested as the DTI ratio. The staff believes it is appropriate to permit the market to develop more experience with residual income before considering whether to incorporate it as an independent requirement of a regulatory presumption of compliance.

The final rule does not contain quantitative thresholds for any of the metrics. The staff is concerned that making a specific DTI ratio or residual income level either a presumptive violation or a presumption of compliance could limit credit availability without providing adequate offsetting benefits. The same debt-to-income ratio can have very different implications for two consumers' repayment ability if the income levels of the consumers differ significantly, making it very difficult to draw bright lines.

Moreover, it is not clear what thresholds would be appropriate, as limited data are available to the Board to support such a determination.

Verification of repayment ability. Currently HOEPA rules contain a provision creating a rebuttable presumption of a violation where a lender engages in a pattern or practice of making HOEPA-covered loans without verifying and documenting repayment ability. The Board proposed to retain this presumption and extend it to higher-priced loans. The final rule is different in two respects. First, as discussed above, the final rule does not contain a "pattern or practice" element. Second, it makes verifying repayment ability an affirmative requirement; failure to verify repayment ability would be a violation and not merely a presumption of a violation. In the final rule, the regulation applies the verification requirement to obligations explicitly. In the proposal, an explicit reference to verifying obligations was in a staff commentary provision explaining the regulation.

The requirement to verify income and assets in the final rule is essentially identical to the proposed requirement. The rule requires creditors to verify assets or income, including expected income, relied on to determine repayment ability. The creditor is required to use third party documents that provide reasonably reliable evidence of the income or assets. The rule also includes an affirmative defense for a creditor that can show that the amounts of the consumer's income or assets relied on were not materially greater than the amount the creditor could have verified at consummation.

Public comments on verification of income and assets relied upon. Commenters generally supported a verification requirement but offered suggestions to modify the proposal. Financial institutions, mortgage brokers, and mortgage industry trade groups raised concerns that the particular requirement proposed would restrict or eliminate access to credit for some borrowers, especially the self-employed, those who earn irregular commission- or cash-based incomes, and low- and moderate-income borrowers. Some consumer and community groups and government officials suggested somewhat stricter requirements. Many of these same commenters, however, contended the proposed affirmative defense would be a major loophole and urged its elimination.

Requirement to verify income or assets using third party documents. The final rule prohibits creditors from relying on amounts of income, including expected income, or assets to assess repayment ability for a higher-priced mortgage or HOEPA-covered loan unless the creditor verifies such amounts. Relying on inflated incomes or assets to determine repayment ability often amounts to disregarding repayment ability, which causes consumers injuries they often cannot reasonably avoid. By requiring verification of income and assets, the final rule is intended to limit these injuries by reducing the risk that higher-priced loans will be made on the basis of inflated incomes or assets.[3] The staff believes the rule is sufficiently flexible to keep costs to consumers, such as any additional time needed to close a loan or costs for obtaining documentation, at reasonable levels relative to the expected benefits of the rule.

The rule specifically authorizes a creditor to rely on W-2 forms, tax returns, payroll receipts, and financial institution records such as bank statements. Most consumers can, or should be able to, produce one of these kinds of documents with little difficulty. For other consumers, the rule is quite flexible. It permits a creditor to rely on any document that provides reasonably reliable evidence of the income or assets relied on

[3] By requiring verification, the rule also addresses the risk that consumers with higher-priced mortgage loans who could document income would unknowingly pay more for a loan that did not require documentation.

to determine repayment ability. Examples include check-cashing receipts or a written statement from the consumer's employer. The one type of document that is excluded is a statement only from the consumer.

The staff has sought to address commenters' concerns about self-employed borrowers. The rule allows for flexibility in underwriting standards so that creditors may adapt their underwriting processes to the needs of self-employed borrowers, so long as creditors comply with the ability to repay rule. For example, the rule does not dictate how many years of tax returns or other information a creditor must review to determine a self-employed applicant's repayment ability.

<u>The affirmative defense</u>. The final rule includes an affirmative defense for a creditor that can show that the amounts of the consumer's income or assets the creditor relied on were not materially greater than what the creditor could have documented at consummation. The preamble accompanying the final rule clarifies that the provision is merely a defense for a lender that did not verify income as required where the failure did not cause injury. The provision places the burden on the lender to prove that its non-compliance was immaterial. Therefore, the defense should not create a loophole, as some commenters believed, and will be available only in limited circumstances such as an occasional failure of reasonable procedures for collecting and retaining appropriate documents.

2. **Prepayment Penalties**

Summary of Proposed and Final Rules

The Board proposed to apply to higher-priced mortgage loans the prepayment penalty restrictions that currently apply to HOEPA-covered loans. Currently, HOEPA-covered loans may have a prepayment penalty only if:

- the penalty period does not exceed five years from loan consummation;
- the penalty does not apply if there is a refinancing by the same creditor or its affiliate; the borrower's debt-to-income (DTI) ratio at consummation does not exceed 50 percent;[4] and
- the penalty is not prohibited under other applicable law.

In addition, the Board proposed, for both HOEPA-covered loans and higher-priced mortgage loans, to require that the penalty period expire at least sixty days before the first date, if any, on which the periodic payment amount may increase under the terms of the loan.

The final rule is different from the proposal. First, the final rule prohibits a prepayment penalty with a higher-priced mortgage loan or HOEPA-covered loan if payments can change during the four-year period following consummation. Second, for all other higher-priced mortgage loans and HOEPA-covered loans – that is, loans whose payments cannot change for four years after consummation – the final rule imposes the following limits:

[4] The final rule, like the proposed rule, applies a stricter income verification standard for income that is not derived from employment than the existing statutory standard for HOEPA-covered loans. Currently, HOEPA requires the income and assets of the consumer to be verified by a financial statement signed by the consumer, by a credit report, and in the case of employment income, by payment records or by verification from the employer of the consumer. The standard in the final rule would require income verification by third-party documents for income that is not derived from employment.

- the prepayment penalty period may not exceed two years from loan consummation; and
- the penalty must not apply in the case of a refinancing by the creditor or its affiliate.

Thus, the final rule shortens the period in which a penalty may be imposed from five years, as proposed and as HOEPA provides, to two years.

The final rule does not include the requirement that a prepayment penalty provision expire at least sixty days before the first date on which a periodic payment amount may increase under the loan's terms because the final rule makes this proposed rule unnecessary.

In addition, the final rule does not include the proposed rule prohibiting a prepayment penalty where a consumer's verified DTI ratio, as of consummation, exceeds 50 percent. This restriction, however, will continue to apply to HOEPA-covered loans, as provided by statute. These aspects of the final rule are discussed in detail below.

<u>Public Comments on the Proposed Rule</u>

Most financial institutions and their trade associations stated that consumers should be able to choose a loan with a prepayment penalty in order to lower their interest rate. Many of these commenters stated that prepayment penalties help creditors to manage prepayment risk, which in turn increases credit availability and lowers credit costs. Industry commenters generally opposed the proposed rule that would prohibit prepayment penalties in cases where a consumer's DTI ratio exceeds 50 percent. The few industry commenters that addressed the proposal to prohibit collection of a penalty in the case of a refinancing by the creditor or its affiliate opposed the provision. Several industry commenters recommended that the Board set a three-year maximum penalty period instead of a five-year maximum.

By contrast, many other commenters, including most consumer organizations, state regulators, a few local, state, and federal government officials, a credit union trade association, and a real estate agent trade association, urged the Board to prohibit prepayment penalties for higher-priced mortgage loans and HOEPA-covered loans. Many of these commenters stated that the cost of prepayment penalties to subprime borrowers outweigh the benefits of any reductions in interest rates or up-front fees they may receive. These commenters stated that the Board's proposed rule would not address adequately the harms that prepayment penalties cause consumers. Several commenters recommended limiting a prepayment penalty period to two or three years following consummation or prohibiting prepayment penalties with ARMs.

Comments about prohibiting or restricting prepayment penalties generally echoed views expressed in public comments associated with, and testimony given at, hearings the Board held in 2006 and 2007 under HOEPA regarding mortgage lending practices. In connection with its most recent HOEPA hearing, the Board asked for comment about how a prohibition or restriction on prepayment penalties would affect consumers and the type and terms of credit offered. Most consumer and community groups, as well as some state and local government officials and a trade association for community development financial institutions, urged the Board to prohibit prepayment penalties with subprime loans. By contrast, most financial institutions and financial services trade groups recommended that the Board limit any regulation of prepayment penalties to improving disclosures and requiring that the period during which a prepayment penalty may be imposed expire before the first reset of a subprime hybrid ARM.

<u>Unfairness Analysis under the FTC Act Standards</u>

The staff believes that prepayment penalties are unfair on higher-priced loans and HOEPA-covered loans, in the circumstances discussed in this section. Prepayment penalty provisions impose significant injuries on consumers that they cannot reasonably avoid. With respect to loans designed to have shorter expected lifespans – such as 2-28 or 3-27 ARMs – staff believes that the injuries from these provisions are potentially most serious as well as the most difficult to avoid, and that these unavoidable injuries outweigh the benefits of such provisions. With respect to loans structured to have longer lifespans, such as fixed-rate mortgages or longer-term hybrid ARMs, the injuries from prepayment penalty provisions are closer to being in balance with their benefits, warranting restrictions but not, at this time, a prohibition.

Paying the penalty means expending several thousand dollars. Not paying it – and some consumers simply cannot – could mean losing an opportunity to lower the interest rate or to tap equity to pay for major medical expenses or other urgent needs. A penalty provision is particularly injurious when coupled with an unaffordable or abusive loan that the consumer needs to refinance; the provision could increase the consumer's odds of defaulting and losing the house.[5]

The risk of injury from a prepayment penalty provision is particularly high with loans structured to have major expected payment increases after as short period.

[5] For the reasons set forth on pages 6-9, consumers in the subprime market have had a high risk of receiving loans they cannot afford to pay. The staff expects that the rule prohibiting disregard for repayment ability will reduce this risk substantially, but no rule can eliminate it. Moreover, its success depends on vigorous enforcement by a wide range of agencies.

Borrowers with these loans are particularly likely to want to prepay these loans quickly to avoid the payment increase; the lower FICO scores of these borrowers also suggests they are more likely to need to refinance quickly to extract cash. Furthermore, in recent years 2-28s and 3-27s have been the most difficult for borrowers to afford even before their payment increases, in part because they were often marketed and underwritten irresponsibly.

Consumers cannot reasonably avoid injuries from prepayment penalty provisions, especially on loans designed to have short expected lifespans. The high incidence of prepayment penalty provisions on subprime loans and the apparently large proportion of these loans whose borrowers actually paid the penalty raise a serious question as to whether many subprime borrowers have knowingly agreed to the provisions. Doubt of their understanding these provisions is also compounded by (a) the many reasons consumers with subprime loans can have to prepay; (b) the lack of transparency of prepayment penalty provisions; (c) and originators' hidden incentives to "push" these provisions on consumers because they increase originators' commissions. Even a consumer offered a genuine choice would have difficulty comparing the costs of loans with and without a penalty, and would likely choose to place more weight on the more certain and tangible cost of the initial monthly payment.

Consumers find it particularly difficult to avoid injuries from prepayment penalty provisions on loans structured with expected short-term payment increases. Such loans are complicated for consumers even without prepayment penalty provisions; adding such a provision makes the transaction more complex as a whole and the provision less likely to be noticed, understood, and fully considered. These loans also appear more likely to create incentives for abusive practices: they are more easily flipped because of the natural incentive to prepay to avoid the payment increase; and they have been marketed as "credit repair" products, implying the consumer can prepay them freely when her credit score improves. Finally, borrowers with 2-28 and 3-27 ARMs may be more vulnerable to these abuses: borrowers with 2-28 and 3-27 ARMs have had lower FICO scores than borrowers with other types of loan, and these borrowers may include the least sophisticated consumers with the fewest financial options.

Prepayment penalty provisions can certainly benefit consumers, especially in the subprime market. These provisions can increase market liquidity by permitting investors to price more directly and efficiently for prepayment risk (compared to pricing for the risk through interest rates or up-front fees charged to all consumers). Penalty provisions therefore should lower credit costs and increase credit availability. Available studies consistently suggest that penalty provisions can reduce credit cost noticeably on fixed-rate mortgages. They also suggest quite consistently, however, that the cost reduction is much smaller on 2-28 and 3-27 ARMs.

Accordingly, staff believes with respect to loans structured to have short expected lifespans that the potential benefits of prepayment penalty provisions do not outweigh the injuries consumers cannot reasonably avoid. With respect to loans structured to have longer durations, however, the injuries from prepayment penalties are closer to being in balance with their benefits. The injuries appear less severe (for example, subprime fixed-rat mortgages have had significantly lower delinquency rates than 2-28 and 3-27 ARMs) and more readily avoidable (for example, these borrowers probably plan to stay in their loans for a longer time, and the loans are not as readily used to "flip" consumers).

Moreover, studies suggest the rate reduction from a prepayment penalty provision is more significant with fixed-rate loans. Therefore, staff believes with respect to loans structured to have longer expected lifespans, such as fixed-rate loans and loans where the payment cannot increase for several years, that the injuries and benefits are closer to being in balance, warranting restrictions but not, at this time, a prohibition.

Discussion of the Final Rule

For both higher-priced mortgage loans and HOEPA-covered loans, the final rule prohibits prepayment penalties if periodic payments can change during the first four years following loan consummation. For all other higher-priced mortgage loans and HOEPA-covered loans, the final rule limits the prepayment penalty period to two years after loan consummation; and prohibits the collection of a prepayment penalty if the same creditor or its affiliate makes the refinance loan. For HOEPA-covered loans only, the final rule retains the current prohibition of penalty provisions for loans with a DTI exceeding 50 percent.

Payment changes in first four years. The final rule prohibits a prepayment penalty provision with a higher-priced mortgage loan or a HOEPA-covered loan whose payments may change during the first four years following consummation. This rule is stricter than the statutory provision on prepayment penalties for HOEPA-covered loans. HOEPA's provision permits such penalties under certain conditions regardless of a potential payment change within the first four years. Section 129(l)(2) requires the Board, however, to prohibit acts or practices it finds to be unfair or deceptive in connection with mortgage loans – including HOEPA-covered loans.

The staff notes that a four-year discount period is not common, but a three-year period was common at least until recently. Using a three-year period in the regulation, however, might simply encourage the market to structure loans with discount periods of three years and one day. Therefore, the final rule provides a four-year period as a prophylactic measure.

Two-year period. The final rule provides that a penalty may not exceed two years from loan consummation. HOEPA limits the maximum prepayment penalty period with HOEPA-covered loans to five years following consummation. The Board proposed to apply this HOEPA provision to higher-priced mortgage loans. However, both industry and consumer organizations recommended shorter periods, from one to three years. As discussed, staff believes that for loans for which the payment cannot change, or can change only after four or more years, prepayment penalties should not be prohibited. Instead, the final rule seeks to ensure the benefits of penalty provisions on these loans are in line with the injuries they can cause by limiting the potential for injury to two years from consummation.

Sixty-day window. The staff does not believe that the proposed requirement that a prepayment penalty period expire at least 60 days before a potential payment increase would adequately protect consumers with loans where the increase was expected shortly. As discussed, these loans, such as 2-28 ARMs, will by nature tend to attract consumers who have a short planning horizon and intend to avoid the payment increase by refinancing. Giving them only a brief window to refinance without penalty puts them in the position of predicting whether they will want to refinance before the window, say in 12 months (in which case they should not accept the penalty, as it is likely greater than the interest rate savings) or within the brief window that will open several months later (in which case they should accept the penalty because they do not expect to pay it). It is not reasonable to expect consumers in the subprime market to make such predictions with any accuracy. Moreover, for transactions on which prepayment penalties are permitted by the final rule, a 60-day window would be moot because the penalty provision may not exceed two years and the payment on a loan with a penalty provision may not change before the fourth year.

Costs imposed by the final rule. The staff recognizes that in response to these restrictions on prepayment penalties, creditors may increase interest rates, up-front fees, or both, and that some subprime borrowers may pay more than they otherwise would or not be able to obtain credit when they would prefer. The staff believes these costs are justified by the benefits of the rule. Based on available studies, the expected increase in costs on the types of loans for which penalty provisions are prohibited is not large. For the remaining types, a reduction in the allowable penalty period from the typical three years to two years should have a very limited, if not necessarily immaterial, effect on costs. Moreover, to the extent cost increases come in the form of higher rates or fees, they will be reflected in the APR, where they may be more transparent to consumers than as a prepayment penalty. Thus, it is not clear that the efficiency of market pricing would decline.

The final rule does not adopt the suggestion of some commenters that it set a maximum penalty amount. A restriction of that kind does not appear necessary or warranted at this time.

Debt-to-income ratio. HOEPA provides that a HOEPA-covered loan may not have a prepayment penalty if the borrower's DTI-ratio at consummation exceeds 50 percent. The proposal would have applied this provision to higher-priced loans and HOEPA-covered loans. The final rule retains this provision for HOEPA-covered loans but does not apply it to higher-priced loans. Commenters generally did not favor the DTI ratio provision. Industry noted that the proposed rule would disadvantage a consumer living in a high-cost area, or those on a fixed income but with significant assets, including many senior citizens. Some consumer organizations also objected to the proposed DTI ratio requirement, stating that the requirement would not protect low-income borrowers with a DTI ratio equal to or less than 50 percent but limited residual income.

The final rule does not include a specific DTI ratio in the rule prohibiting disregard of repayment ability. For the same reasons, the final rule does not adopt the proposed prohibition of a prepayment penalty for all higher–priced loans where a consumer's DTI ratio at consummation exceeds 50 percent. The final rule does, however, leave the prohibition in place as it applies to HOEPA-covered loans, as this prohibition is statutory and its removal does not appear warranted at this time.

3. Escrows

Summary of the Proposed and Final Rules

The Board proposed to require a creditor to establish an escrow account for property taxes and homeowners insurance on a higher-priced loan secured by a first lien on a consumer's principal dwelling. Under the proposal, a creditor could have allowed a consumer to cancel the escrow account, but no sooner than 12 months after consummation. The final rule adopts the proposal with exceptions for loans secured by cooperative apartments and certain condominium loans. The rule also provides a longer compliance period for escrows, to give creditors and servicers time to develop an escrow infrastructure for higher-priced loans.

Public Comments on the Proposed Rule

Many community banks and mortgage brokers as well as several industry trade associations opposed the proposed escrow requirement. They argued that consumers are adequately protected by the proposed requirement to consider a consumer's ability to pay tax and insurance obligations, and by a disclosure of estimated taxes and insurance they recommended the Board adopt. Commenters also contended that setting up an escrow infrastructure would be very expensive and costs would be passed on to consumers

Some individual consumers who commented expressed a preference for paying their taxes and insurance themselves out of fear that servicers may fail to pay these obligations fully and on-time. Many requested that, if escrows are required, creditors be required to pay interest on the escrowed funds.

Several industry trade associations, several large creditors and some mortgage brokers, however, supported the proposed escrow requirement. They were joined by the consumer groups, community development groups, and state and federal officials that commented on the issue. Many of these commenters argued that failure to escrow leaves consumers unable to afford the full cost of homeownership and facing expensive force-placed insurance or default, and possibly foreclosure. Commenters supporting the proposal differed on whether and under what circumstances creditors should be permitted to cancel escrows.

Large creditors without escrow systems asked for 12 to 24 months to comply if the proposal is adopted.

Unfairness Analysis Under the FTC Act Standards

The staff believes that it is unfair under the FTC Act standards for a creditor to make a first-lien higher-priced loan or a first-lien HOEPA-covered loan without offering an escrow. Escrow accounts for property taxes and homeowners' insurance premiums are a common feature in the prime mortgage market. The benefits of escrows are that they reduce the likelihood that consumers will assume unaffordable mortgages, act as a kind of forced savings that relieves the consumer of the need to save separately to pay property taxes and homeowners' insurance premiums, and may reduce the risk of default. In the subprime mortgage market, however, it does not appear that most borrowers are offered the opportunity to escrow property taxes and homeowners' insurance premiums.

The lack of escrows in the subprime market reflects a market failure. Originators that do not offer escrows to borrowers are able to quote monthly payments that do not include amounts for taxes and insurance. These originators have a competitive advantage over originators that require or offer escrows. The result is a collective action problem where even though originators would benefit from escrows, individual originators do not offer escrows because doing so could put them at a competitive disadvantage.

This market failure causes substantial injury to borrowers. A lack of escrows in the subprime market may make it more likely that borrowers obtain mortgages they cannot afford. Borrowers who cannot afford to save or have not been adequately informed of the need to save for taxes and insurance may not have the resources to pay tax and insurance bills when they come due. Failure to pay property taxes and homeowners' insurance premiums is generally an act of default which may subject the property to a public auction by the local government or an acquisition by a public agency. Borrowers faced with unpaid tax or insurance bills are particularly vulnerable to predatory lending practices. Borrowers cannot avoid this injury if they are not offered loans with escrow and do not understand the risks and responsibilities associated with a non-escrowed loan. Although the practice of not escrowing potentially can benefit borrowers who can separately meet their property tax and homeowners' insurance obligations, staff believes these benefits are outweighed by the injury to borrowers from not having an opportunity to escrow on higher-priced mortgages.

Discussion of the Final Rule

The rule assures a genuine opportunity to escrow by requiring creditors that originate first-lien higher-priced loans to establish an escrow with each loan. A mandatory escrow account on a first lien loan ensures that funds are set aside for payment of property taxes and insurance premiums. The staff recognizes that escrows can impose certain financial cost on both creditors and borrowers. Creditors are likely to pass on to consumers, either in part or entirely, the cost of setting up and maintaining escrow systems, whether done in-house or outsourced. The staff also recognizes that prohibiting consumers from canceling before 12 months have passed will impose costs on individual consumers who prefer to pay property taxes and insurance premiums on their own, and to earn interest on funds that otherwise would be escrowed.

The staff believes, however, that the benefits of the rule outweigh these costs. Moreover, the rule preserves some degree of consumer choice by permitting a creditor to provide the consumer an option to cancel an escrow account 12 or more months after consummation. The staff considered alternatives that would avoid requiring a creditor to set up an escrow system, or that would require a creditor to offer an escrow, but permit consumers to opt-out of escrows at closing. These alternatives would not provide consumers sufficient protection from the injuries discussed above.

The staff recognizes that some creditors currently may not have the capacity to escrow for all first-lien higher-priced mortgage loans. Several industry representatives stated that the escrow requirement would require major system and infrastructure changes by creditors that do not currently have escrow capabilities. They asked for an extended compliance deadline of 12 to 24 months prior to the effective date of the final rule to allow for necessary escrow systems and procedures to develop. The final rule for escrows takes effect for higher-priced first lien loans consummated on or after April 1, 2010; however, for reasons discussed below, the final rule for higher-priced first lien loans secured by manufactured housing is effective for such loans consummated on or after October 1, 2010.

Manufactured Housing. Manufactured housing industry commenters requested that manufactured housing loans be exempted from the escrow requirement. Manufactured housing loans are mostly personal property loans taxed in many local jurisdictions like other personal property. Creditors and servicers do not require and do not offer escrows on manufactured housing loans. Many taxing jurisdictions do not automatically report property taxes to creditors and creditors have to go through extra steps to obtain that information.

The final rule does not exempt loans secured by manufactured homes from the escrow requirement. The staff believes that escrows for manufactured housing loans are necessary to prevent creditors from understating the cost of homeownership and to educate consumers that their manufactured home is subject to property taxes. Because there is a limited infrastructure for escrowing on manufactured housing loans, the staff believes that additional time is needed for creditors and servicers to set up the infrastructure for or contract out for escrows. Therefore, the final rule provides for an extended effective date of October 1, 2010 for loans secured by manufactured housing.

C. Prohibited Acts and Practices in Connection with Closed-End Credit Secured by a Consumer's Principal Dwelling

The final rules that address coercion of appraisers and loan servicing apply to closed-end consumer credit transactions secured by a consumer's principal dwelling. Open-end home-equity plans are excluded. The acts and practices addressed in this section are not limited to the subprime market. Thus, the prohibitions are not limited to higher-priced mortgage loans.

1. Coercion of Appraisers

Summary of Proposed and Final Rules

The Board proposed to prohibit creditors and mortgage brokers and their affiliates from coercing, influencing, or otherwise encouraging appraisers to misstate or misrepresent the value of a consumer's principal dwelling. The Board also proposed to prohibit a creditor from extending credit when it knows or has reason to know, at or before loan consummation, that an appraiser has been encouraged by the creditor, a mortgage broker, or an affiliate of either, to misstate or misrepresent the value of a consumer's principal dwelling, unless the creditor acts with reasonable diligence to determine that the appraisal was accurate or extends credit based on a separate appraisal untainted by coercion. The final rule is substantially similar to the proposed rule.

Public Comments on the Proposed Rule

Consumer and community advocacy groups, appraiser trade associations, state appraisal boards, individual appraisers, some financial institutions and banking trade associations, and a few other commenters expressed general support for the promulgation of a rule to prohibit appraiser coercion. Several of these commenters stated that the rule would enhance enforcement against parties that are not subject to the same oversight as depository institutions, such as independent mortgage companies and mortgage brokers. Some of the commenters who supported the rule also suggested including additional practices in the list of examples of prohibited conduct. In addition, several appraiser trade associations jointly recommended that the Board prohibit appraisal management companies from coercing appraisers.

On the other hand, community banks, consumer banking and mortgage banking trade associations, and some large financial institutions opposed the proposed rule, stating that its adoption would lead to nuisance suits by borrowers who regret the amount they paid for a house and would make creditors liable for the actions of mortgage brokers and appraisers. Several of these commenters stated that the Board's rule would duplicate requirements set by existing laws and guidance, including federal regulations, interagency guidelines, state laws, and the Uniform Standards of Professional Appraisal Practice (USPAP). Further, some of these commenters stated that creditors have limited ability to detect undue influence and should be held liable only if they extend credit knowing that a violation of § 226.36(b)(1) had occurred.

Many commenters discussed appraisal-related agreements that Fannie Mae and Freddie Mac each have entered into with the Attorney General of New York and the

Office of Federal Housing Enterprise Oversight (GSE Appraisal Agreements), which incorporated a Home Valuation Code of Conduct. These commenters urged the Board to coordinate with the parties to the GSE Appraisal Agreements to promote consistency in the standards that apply to the residential appraisal process.

Unfairness Analysis Under the FTC Act Standards

The staff believes that coercion of appraisers in connection with a loan to be secured by the consumer's principal dwelling is unfair under the FTC Act standards. Pressuring an appraiser to understate or overstate the value of a consumer's dwelling can distort the lending process and harm consumers. An inflated appraisal can lead a consumer to think he or she has more home equity than he or she in fact has and to borrow or make other financial decisions based on this incorrect information. Inflated appraisals of homes concentrated in a neighborhood may affect other appraisals and thus other consumers, since appraisers factor the value of comparable properties into their property valuations.

Consumers who are party to a consumer credit transaction cannot prevent creditors or mortgage brokers from influencing appraisers to misstate or misrepresent a dwelling's value. Consumers will not necessarily be aware that a creditor or mortgage broker is pressuring an appraiser to misstate or misrepresent the value of the principal dwelling they offer as collateral for a loan. Furthermore, consumers who own property near a dwelling securing a consumer credit transaction but are not parties to the transaction are not in a position to know that a creditor or mortgage broker is coercing an appraiser to misstate a dwelling's value

Coercing, influencing, or otherwise encouraging appraisers to misstate or misrepresent value does not benefit consumers or competition. Acts or practices that promote the misrepresentation of the market value of a dwelling distort the market, and any competitive advantage a creditor or mortgage broker obtains through influencing an appraiser to misstate a dwelling's value, or that a creditor gains by knowingly originating loans based on a misstated appraisal, is an unfair advantage.

Discussion of the Final Rule

Rule prohibiting coercion. The staff believes the rule is necessary to help prevent coercion, even though as industry commenters noted, creditors have a disincentive to coerce appraisers to misstate value. Loan originators may believe that they stand to benefit from coercing an appraiser to misstate value, for example, if their compensation depends more on volume of loans originated than on loan performance. In addition, the staff believes the rule complements but does not duplicate existing guidance, contrary to industry commenters' assertions. The rule is aimed at the conduct of creditors and mortgage brokers, while guidance such as the USPAP is aimed at appraisers' behavior. Moreover, guidance for federally supervised financial institution on appraiser independence does not apply to independent mortgage companies and mortgage brokers. The Board's rule would apply to all TILA creditors and mortgage brokers.

Extension of credit. The final rule prohibits a creditor from extending credit if the creditor knows, at or before loan consummation, of a violation of the rule (for example, by an employee of the creditor or a mortgage broker), unless the creditor acted with reasonable diligence to determine that the appraisal does not materially misstate the value of the consumer's principal dwelling. The Staff Commentary provides that a creditor is deemed to have acted with reasonable diligence if the creditor extends credit based on an appraisal other than the one subject to the restriction.

The proposal would have prohibited the creditor from extending credit when it knows or has reason to know of a violation. Some financial institutions and financial institution trade associations stated that the phrase "reason to know" is vague and that creditors should be held liable for violations only if they extend credit when they had actual knowledge that a violation exists. The final rule removes the "reason to know" text but the preamble makes clear that creditors may not extend credit in willful disregard of facts that evidence a violation of the rule. Many banks asked for guidance on how to determine whether an appraisal "materially" misstates a dwelling's value. The staff has addressed this request through a new comment that provides that a misrepresentation or misstatement of a dwelling's value is not material if it does not affect the credit decision or the terms on which credit is extended.

2. Loan Servicing

Summary of Proposed and Final Rules

The Board proposed to prohibit certain practices of servicers of closed-end consumer credit transactions secured by a consumer's principal dwelling. The proposal stated that no servicer shall: (1) fail to credit a consumer's periodic payment as of the date received; (2) impose a late fee or delinquency charge where the late fee or delinquency charge is due only to a consumer's failure to include in a current payment a late fee or delinquency charge imposed on earlier payments; (3) fail to provide a current schedule of servicing fees and charges within a reasonable time of request; or (4) fail to provide an accurate payoff statement within a reasonable time of request. The final rule adopts the proposal with the exception of the requirement for a schedule of fees, for reasons discussed below.

Public Comments on the Proposed Rule

Consumer advocacy groups, federal and state regulators and officials, consumers and others strongly supported the Board's proposal to address servicing abuses, although some urged alternative measures to address servicer abuses. Industry commenters, on the other hand, were generally opposed to the proposals, particularly the fee schedule. Industry commenters also urged the Board to adopt any such rules under its authority in TILA Section 105(a) to adopt regulations to carry out the purposes of TILA, and not under Section 129(l)(2). Comments on specific provisions are set out below.

Unfairness Analysis Under the FTC Act Standards

The staff believes that engaging in the servicing practices described above in connection with the servicing of a loan secured by the consumer's principal dwelling is unfair under the FTC Act standards. Consumers subject to these practices suffer substantial injury. Servicers that do not timely credit, or that misapply, payments cause the consumer to incur late fees where none should be assessed. Even where the first late fee is properly assessed, servicers may apply future payments to the late fee first. Doing so results in future payments being deemed late even if they are, in fact, paid in full within the required time period, thus permitting the servicer to charge additional late fees—a practice commonly referred to as "pyramiding" of late fees. In addition, a servicer's failure to provide accurate payoff statements in a timely fashion can cause substantial injury to consumers. Consumers may want to refinance a loan to obtain a lower interest rate or to avoid default or foreclosure, but may be impeded from doing so due to inaccurate or untimely payoff statements.

Market competition is not adequate to assist consumers in reasonably avoiding abusive practices, particularly when mortgages are securitized and servicing rights are sold. Under the originate-to-distribute model, the initial creditor has become removed from future direct involvement in a consumer's loan, and thus has less incentive and ability to detect or deter servicing abuses or respond to consumer complaints about servicing abuses. When loans are securitized, servicers contract directly with investors to service the loan, and consumers are not a party to the servicing contract. Consumers are not able to choose their servicers. Consumers also are not able to change servicers without refinancing, which is a time-consuming, expensive undertaking.

The injuries described above also are not outweighed by any countervailing benefits to consumers or competition.

<u>Discussion of the Final Rule</u>

<u>Prompt crediting</u>. The final rule requires prompt crediting substantially as proposed. Commenters generally favored, or did not oppose, the prompt crediting rule. In particular, consumer advocacy groups, federal and state regulators and officials, and others supported the rule. However, some industry commenters and others requested clarification on certain implementation details. Commenters also disagreed about whether and how to address partial payments. The final rule and commentary provide that creditors are not required to credit partial payments, and that whether a payment is a full or partial payment is determined by the legal obligation between the consumer and creditor (e.g., the loan agreement or promissory note).

Fee pyramiding. The final rule prohibits fee pyramiding. Commenters generally supported prohibiting fee pyramiding. Several commenters argued, however, that a new rule would be unnecessary because servicers are subject to a regulation prohibiting fee pyramiding, whether they are banks, thrifts, credit unions or other institutions. However, by issuing the rule under HOEPA, state attorneys general can enforce the rule against servicers.

Payoff statements. The final rule requires servicers to provide accurate payoff statements within a reasonable time upon request. Consumer advocates strongly supported the proposal. Community banks stated that the proposed example of a reasonable time – three business days – would typically be adequate. However, large financial institutions and their trade associations urged the Board to adopt a longer time period in the commentary. Staff believes a longer time frame is warranted, thus the commentary provides a time frame of five business days as a safe harbor.

Fee schedule. The final rule does not include the fee schedule requirement. Most commenters opposed the fee schedule proposal. Consumer advocates urged the Board to adopt alternative measures they argued would be more effective to combat fee abuses. Industry commenters objected to the proposal as impracticable and unnecessarily burdensome, particularly with respect to third party fees. Staff believes that itemizing third party fees is impracticable, as they can vary greatly and may be indeterminable before being charged to consumers. Moreover, the fee schedule may be of limited value to consumers. Staff plans to consider disclosure of servicing fees through periodic statements or other formats in the comprehensive review of Regulation Z mortgage disclosures.

3. Yield Spread Premiums (Mortgage Broker Compensation)

Potential Unfairness Associated with Yield Spread Premiums

A "yield spread premium" is a payment by a creditor to a mortgage broker in connection with a loan. A yield spread premium is the present dollar value of the difference between the lowest interest rate a wholesale lender would have accepted on a particular transaction and the interest rate a mortgage broker actually obtained for the lender. Some or all of this dollar value is usually paid to the mortgage broker by the creditor as a form of compensation, though it may also be applied to other closing costs.

Significant concerns have been raised about the fairness and transparency of creditor payments to mortgage brokers. It is likely that many consumers do not know that creditors pay brokers based on the interest rate and mistakenly believe that the broker will obtain the best interest rate available for the consumer. Some consumers may not even know that creditors pay brokers because it is a common practice for brokers to charge a small part of their compensation directly to the consumer. Consumers who do not understand how creditors compensate brokers may not realize that brokers have an incentive to increase the rate in the consumer's loan transaction in order to maximize the broker's compensation. Finally, consumers who do not understand the broker's incentives may be less likely to shop for rates from various sources or shop and negotiate for brokers' services.

The Proposed Rule

The Board proposed to prohibit a creditor from paying a mortgage broker in connection with a covered transaction more than the consumer agreed in writing, in advance, that the broker would receive. The broker would also disclose that the consumer ultimately would bear the cost of the entire compensation even if the creditor paid any part of it directly; and that a creditor's payment to a broker could influence the broker to offer the consumer loan terms or products that would not be in the consumer's interest or the most favorable the consumer could obtain. Proposed commentary provided model language for the agreement and disclosures. The Board stated that it would test this language with consumers before determining how it would proceed on the proposal.

Public Comments on the Proposed Rule

Mortgage brokers, their federal and state trade associations, the Federal Trade Commission, and several consumer groups argued that applying the proposed disclosures to mortgage brokers but not to creditors' employees who originate mortgages ("loan officers") would reduce competition in the market and harm consumers. They contended that disclosing a broker's compensation would cause consumers to believe, erroneously, that a loan arranged by a broker would cost more than a loan originated by a loan officer. These commenters stated that many brokers would unfairly be forced out of business, and consumers would pay higher prices, receive poorer service, or have fewer options. The FTC, citing its published report of consumer testing of mortgage broker compensation disclosures, contended that focusing consumers' attention on the amount of the broker's compensation could confuse consumers and, under some circumstances, lead them to select a more expensive loan.

Mortgage brokers and creditors expressed concerns that the proposed rule would not be practicable in cases where creditors take applications and forward them to other creditors after determining that they cannot make the loan; and where brokers decide to fund an application using a warehouse line of credit. Creditors and brokers decide to change roles only after reviewing a consumer's application, while the proposal requires the broker disclosure be delivered before the consumer has applied or paid a fee.

Consumer advocates, members of congress, the FDIC, and others stated that the proposal would not address the conflict of interest between consumers and brokers that rate-based compensation of brokers (the yield spread premium) can cause. These commenters urged that the only effective remedy for the conflict is to ban this form of compensation. State regulators expressed concern that the proposed disclosures would not provide consumers sufficient information, and could give brokers a legal "shield" against claims they acted contrary to consumers' interests.

Creditors and their trade associations, on the other hand, generally supported the proposal, although with a number of suggested modifications. These commenters agreed with the Board that yield spread premiums create financial incentives for brokers to steer consumers to less beneficial products and terms. They saw a need for regulation to remove or limit these incentives.

Reasons for Withdrawing the Proposal

Based on consumer testing and other information, the staff is concerned that the proposed agreement and disclosures would confuse consumers and undermine their decision-making rather than improve it. The risks of consumer confusion arise from two sources. First, an institution can act as either creditor or broker depending on the transaction; but an institution typically decides to do so only after reviewing the consumer's application. However, the proposed rule required the broker-consumer agreement (with disclosures) be executed before the consumer has applied or paid a fee.

This timing requirement would likely cause creditors and brokers to provide the broker disclosure/agreement to every consumer so as to ensure compliance with the rule. If, for example, a creditor gave the disclosure stating its commission for acting as a broker, took the consumer's application and then decided to make the loan as a creditor, the consumer would have received inaccurate and confusing information.

Second, consumers who participated in the Board's testing about the proposed agreement and disclosures often concluded, erroneously, that they would pay less commission when working directly with a lender than working through a broker. Many participants also disregarded the conflict of interest disclosure, either because it conflicted with their belief that brokers work in the consumer's best interest, or because they did not know that brokers have discretion in setting consumers' interest rates.

The staff will continue to explore whether there are options available to the Board to address unfair acts or practices associated with originator compensation arrangements such as yield spread premiums. Of particular concern are arrangements that cause the interests of originators to conflict with those of consumers, i.e., where originators' incentives are not transparent to consumers who rely on the originators for advice. As the staff comprehensively reviews Regulation Z, it will continue to consider whether there are disclosures or other approaches that can address this problem.

D. Advertising

Background

Regulation Z currently contains rules that apply to advertisements of open-end home-equity plans and closed-end mortgage credit. The advertisement of rates is addressed in these rules. In addition, if an advertisement contains certain specified credit terms, including the payment terms, this triggers a requirement to provide additional advertising disclosures, such as the APR.

In developing the proposal, a review of recent advertisements for mortgage loans shows that some advertisements emphasize low introductory or “teaser” rates or payments that will only be in effect for a limited period of time. These advertisements generally disclose the rates or payments that will apply after the low introductory rates or payments expire in a much less conspicuous manner, such as in much smaller type or in a footnote. Some advertisements also promote a rate, such as an “effective” rate or “payment” rate, that is lower than the rate at which interest is accruing. Advertisements such as these do not provide consumers with accurate or balanced information about the cost of credit over the term of the loan and the obligations that consumers would assume under the mortgage.

In addition, certain practices connected with closed-end mortgage advertisements appear to be misleading for consumers. For example, certain closed-end mortgage advertisements for adjustable-rate mortgages use the term “fixed” in a way that could mislead the consumer into believing that the product is a fixed-rate mortgage. Other such advertisements suggest that the federal government sponsors or endorses the loan product being advertised.

Summary of Proposed Rules

The Board proposed to amend the advertising rules for open-end home-equity plans and for closed-end credit to address advertisements for home-secured loans. For open-end home-equity plan advertisements, the two most significant proposed changes related to the clear and conspicuous standard and the advertisement of promotional terms.

For advertisements for closed-end credit secured by a dwelling, the three most significant proposed changes related to strengthening the clear and conspicuous standard for advertising disclosures, regulating the disclosure of rates and payments in advertisements to ensure that low promotional or “teaser” rates or payments are not given undue emphasis, and prohibiting certain acts or practices in advertisements as provided under Section 129(l)(2) of TILA.

Public Comments on the Proposed Rule

Most commenters were generally supportive of the Board’s proposed advertising rules. Lenders and their trade associations made a number of requests for clarification or modification of the rules, and a few cautioned that requiring too much information in advertisements could cause creditors to avoid advertising specific credit terms, thereby depriving consumers of useful information. By contrast, consumer and community groups as well as state and local government officials made some suggestions for tightening the application of the rules.

Although most industry commenters supported the Board’s efforts to address misleading advertising acts and practices, many urged the Board to use its general rulewriting authority under TILA rather than HOEPA’s UDAP authority. They expressed concern that promulgating the prohibitions under HOEPA may expose creditors to extensive private legal action for inadvertent technical violations.

Commenters were divided on whether to extend the proposed prohibitions to HELOCs. Many community banks agreed with the Board that the misleading or deceptive acts often associated with mortgage and mortgage refinancing advertisements do not occur in HELOC advertisements. Some consumer groups and state regulators, however, urged the Board to extend all of the prohibitions to HELOCs. Few commenters suggested that the Board consider any additional prohibitions on misleading advertising either for closed-end mortgage loans or HELOCs.

Discussion of the Final Rule

The final rule is substantially similar to the proposed rule and adopts, with some modifications, each of the proposed changes discussed above. The most significant changes are: modifying when an advertisement is required to disclose certain information about tax implications; providing a safe harbor for when promotional rates or payments are to be deemed reasonably current for radio and television advertisements; allowing advertisements for closed-end credit to state that payments do not include mortgage insurance premiums rather than requiring advertisements to state the highest and lowest payment amounts; and removing the prohibition on the use of the term "financial advisor" by a for-profit mortgage broker or mortgage lender.

Advertising rates or payments. The final rule requires that whenever a rate or payment is included in an advertisement for closed-end or open-end credit secured by a dwelling, all rates or payments that will apply over the term of the loan (and the time periods for which those rates or payments apply) must be disclosed with equal prominence and in close proximity to the advertised rate or payment. For example, if the advertised monthly payment is $1,000, but increases to $2,000 after six months, the payment increase and the limited duration of the initial monthly payment could not be disclosed in smaller type or in a footnote, but must be disclosed close to and as prominently as the $1,000 initial monthly payment. Moreover, for closed-end mortgage advertisements, the final rule no longer allows the advertisement of any interest rate lower than the rate at which interest is accruing on an annual basis.

Prohibited practices in closed-end mortgage advertisements. The final rule prohibits the following practices (as deceptive) in advertisements for closed-end mortgage loans:

- Advertising "fixed" rates or payments without adequately disclosing that the interest rate or payment amounts are "fixed" only for a limited period of time, rather than for the full term of the loan;

- Comparing an actual or hypothetical consumer's current rate or payment obligations and the rates or payments that would apply if the consumer obtains the advertised product, unless the advertisement states the rates or payments that will apply over the full term of the loan;

- Advertisements that characterize the products offered as "government loan programs," "government-supported loans," or otherwise endorsed or sponsored by a federal or state government entity, unless the loans are government-supported or sponsored loans, such as FHA or VA loans;

- Advertisements that prominently display the name of the consumer's current mortgage lender, unless the advertisement also discloses the fact that the advertisement is from a mortgage lender that is not affiliated with the consumer's current lender;

- Advertising claims of debt elimination if the product advertised would merely replace one debt obligation with another;

- Advertisements that falsely create the impression that the mortgage broker or lender has a fiduciary relationship with the consumer (by using the term "counselor"); and

- Foreign-language advertisements in which certain information, such as a low introductory "teaser" rate, is provided in a foreign language, while required disclosures are provided only in English.

With respect to advertisements creating a false impression of a fiduciary relationship, the proposal would have prohibited the use of the terms "financial advisor" or "counselor" to refer to for-profit mortgage brokers and creditors. The final rule prohibits only the use of the term "counselor." Some industry commenters noted that registered securities broker-dealers and other licensed financial professionals, who may also be licensed as mortgage brokers, may place advertisements for mortgage loans, often in conjunction with a range of other financial products. The staff recognizes that financial advisors play a legitimate role in assisting consumers in selecting appropriate home-secured loans, and does not believe that the rule should prevent the legitimate business use of, or otherwise conflict or intervene with federal and state laws that contemplate the use of, the term "financial advisor.

These prohibitions apply to advertisements for all closed-end mortgage loans, but would not apply to advertisements for open-end home-equity plans. Staff did not observe the practices described above in advertisements for home-equity plans.

E. <u>Timing of Disclosures</u>

<u>Background</u>

Regulation Z currently provides that a creditor must make certain early disclosures to consumers in connection with a loan to purchase a consumer's primary dwelling (also known as a "residential mortgage transaction") subject to the Real Estate Settlement Procedures Act. For these transactions, the creditor must make a good faith estimate of the disclosures before consummation, or deliver or place them in the mail not later than three business days after the creditor receives the consumer's written application, whichever is earlier. The required disclosures include the payment schedule, total of payments, finance charge, amount financed, and annual percentage rate.

The current rule does not require "early" disclosures for non-purchase money mortgage transactions, such as mortgage refinancings, closed-end home equity loans, and reverse mortgages. Currently under Regulation Z, creditors need not provide mortgage loan disclosures to consumers in non-purchase money mortgage transactions until consummation. By the time of consummation, consumers may not be in a position to use the disclosures to shop for a mortgage or to inform themselves adequately of the terms of the loan.

The current rule also does not restrict the imposition of fees, such as non-refundable application fees, before good faith estimate disclosures have been provided to the consumer. Imposing such fees before transaction-specific disclosures have been provided may have the effect of limiting shopping by consumers.

Summary of Proposed Revisions

The proposal would revise the current rule to require creditors to provide early good faith estimate disclosures to consumers in both purchase money and non-purchase money closed-end mortgage transactions. In addition, the proposal would prohibit a creditor or any other person from imposing a fee on the consumer in connection with the consumer's application for a closed-end mortgage transaction until after the consumer has received the disclosures. For purposes of determining when a fee may be imposed, the consumer would be deemed to have received the disclosures three business days after they are mailed. This fee restriction would not apply to a reasonable and bona fide fee for obtaining the consumer's credit history, such as a credit report fee. Providing transaction-specific information within three days of application and before the consumer has paid a fee would help to ensure that consumers have a meaningful opportunity to review the credit terms being offered, assess whether the terms meet their needs and are affordable, and decide whether to proceed with the transaction or continue to shop among alternatives.

Public Comments on the Proposed Rule

Many creditors and their trade associations opposed the proposal, arguing that the operational cost and compliance difficulties (for example, system reprogramming, testing, procedural changes, and staff training) outweigh the benefits of improving consumers' ability to shop among alternative loans. They noted that the burden may be significant for some creditors, such as community banks. Citing operational difficulties, many industry commenters requested a compliance period of up to 18 months from the effective date of the final rule. They also expressed concern about the scope of the fee restriction and its application to third party originators.

Consumer groups, state regulators and enforcement agencies that commented on proposed § 226.19(a)(1) generally supported the proposed rule because it would increase the availability of information to consumers when they are shopping for loans. Some, however, argued for greater enforceability and redisclosure before consummation of the loan transaction to enhance the accuracy of the information disclosed.

Discussion of the Final Rule

The final rule is intended to help consumers make informed use of credit and enable them to better shop for credit alternatives. Under current Regulation Z, creditors need not deliver a mortgage loan disclosure on non-purchase mortgage transactions until consummation. By that time consumers may not be in a position to make meaningful use of the disclosure. Once consumers have reached the settlement table, it is likely too late for them to use the disclosure to shop for mortgages or to inform themselves adequately of the terms of the loan. Consumers receive at settlement a large, often overwhelming, number of documents, and may not reasonably be able to focus adequate attention on the mortgage loan disclosure to verify that it reflects what they believe to be the loan's terms. Moreover, by the time of loan consummation, consumers may feel committed to the loan because they are accessing equity for an urgent need, may be refinancing a loan to obtain a lower rate (which may only be available for a short time), or may have already paid substantial application fees.

The mortgage loan disclosure that consumers will receive early in the application process under the final rule includes a payment schedule, which will illustrate increases in payments resulting from discounted variable-rate terms or if other temporary initial rates expire. The disclosure also includes an APR that reflects the fully indexed rate for hybrid and payment-option ARMs, which sometimes are marketed on the basis of only an initial, discounted rate or a temporary, minimum monthly payment. Providing this information not later than three business days after application, and before the consumer has paid a substantial fee, will help ensure that consumers have a genuine opportunity to review the credit terms offered; that the terms are consistent with their understanding of the transaction; and that the credit terms meet their needs and are affordable. This information will further enable the consumer to decide whether to move forward with the transaction or continue to shop among alternative loans and sources. The staff is reviewing the content of the mortgage disclosures as part of the comprehensive review of Regulation Z.

The staff recognizes that the early mortgage loan disclosure rule will impose additional costs on creditors, some of which may be passed on in part to consumers.

Some creditors already deliver early mortgage loan disclosures on non-purchase money mortgages. Not all creditors, however, follow this practice, and those that do not will also incur one-time implementation costs to modify their systems in addition to ongoing costs to originate loans. The staff believes, however, that the benefits to consumers of receiving early estimates of loan terms, such as enhanced shopping and competition, offset any additional costs.

F. <u>Effective dates</u>

Under TILA Section 105(d), certain of the Board's disclosure regulations are to have an effective date of October 1, following by at least six months the date of promulgation. However, the Board may, at its discretion, lengthen the implementation period for creditors to adjust their forms to accommodate new requirements, or shorten the period where the Board finds that such action is necessary to prevent unfair or deceptive disclosure practices. No similar effective date requirement exists for non-disclosure regulations.

The Board requested comment on whether six months would be an appropriate implementation period, and on the length of time necessary for creditors to implement the proposed rules, as well as whether the Board should specify a shorter implementation period for certain provisions to prevent unfair or deceptive practices. Three organizations of state consumer credit regulators who jointly commented suggested that some of the proposed revisions could be enacted quickly without any burden to creditors, and requested implementation as soon as possible. Many industry commenters and their trade associations stated that although six months is an appropriate time period to implement some parts of the rule, creditors would need additional time to make system enhancements and to implement compliance training for other parts of the rule. For example, they stated that extra time is needed to establish systems to identify loans at or above the APR trigger for higher-priced mortgages. Most commenters who addressed the effective date specifically requested a compliance period longer than six months for the proposed early mortgage loan disclosure requirement and the proposed escrow requirement. In light of these concerns, the Board believes additional compliance time beyond six months is appropriate. Therefore, the final rule is effective as specified below.

Based on the comments, the staff believes that more than six months' time is needed to comply with the revised regulation. Thus, the final rules generally will be effective as of October 1, 2009. For escrows, as discussed, although many creditors currently provide for escrows, large creditor commenters and their trade associations requested the effective date be delayed by twelve to twenty-four months to allow creditors that currently have no escrowing capacity or infrastructure to implement the necessary systems and processes. Manufactured housing industry commenters were particularly concerned because, as discussed, currently a limited infrastructure is in place for escrowing on manufactured housing loans. Staff believes these concerns are warranted, and accordingly, the requirement to establish an escrow account for taxes and insurance for higher-priced loans and for HOEPA loans secured by manufactured housing is effective for such loans consummated on or after October 1, 2010; and for all other higher-priced loans and HOEPA-covered loans, for such loans consummated on or after April 1, 2010.

Conclusion

Staff recommends that the Board publish final amendments to Regulation Z to: (1) prohibit certain acts or practices for higher-priced mortgage loans; (2) prohibit other acts or practices for closed-end credit transactions secured by a consumer's principal dwelling; (3) revise the disclosures required in advertisements for credit secured by a consumer's dwelling and prohibit certain practices in connection with closed-end mortgage advertising; and (4) require disclosures for closed-end mortgages to be provided earlier in the transaction. Staff also recommends that the Board publish proposed amendments to Regulation C to make higher-priced loan reporting consistent with the Regulation Z amendments.