FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Regulation Z; Docket No. R-1090]

Truth in Lending

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board is proposing amendments to the provisions of Regulation Z (Truth in Lending) that implement the Home Ownership and Equity Protection Act (HOEPA). HOEPA was enacted in 1994, in response to evidence of abusive lending practices in the home-equity lending market. HOEPA imposes additional disclosure requirements and substantive limitations (for example, restricting short-term balloon notes) on home-equity loans bearing rates or fees above a certain percentage or amount. The amendments would broaden the scope of mortgage loans subject to HOEPA by adjusting the price triggers used to determine coverage under the act. The rate-based trigger would be lowered by two percentage points and the fee-based trigger would be revised to include optional insurance premiums and similar credit protection products paid at closing. Certain acts and practices in connection with home-secured loans would be prohibited, including rules to restrict creditors from engaging in repeated refinancings of their own HOEPA loans over a short time period when the transactions are not in the borrower's interest. HOEPA's prohibition against extending credit without regard to consumers' repayment ability would be strengthened. Disclosures received by consumers before closing for HOEPA-covered loans would be enhanced.

DATES: Comments must be received on or before March 9, 2001.

ADDRESSES: Comments, which should refer to Docket No. R-1090, may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551 or mailed electronically to regs.comments@federalreserve.gov. Comments addressed to Ms. Johnson may also be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m. weekdays, and to the security control room at all other times. The mail room and the security control room, both in the Board's Eccles Building, are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, N.W. Comments may be inspected in room MP-500 in the Board's Martin Building between 9:00 a.m. and 5:00 p.m., pursuant to the Board's Rules Regarding the Availability of Information, 12 CFR part 261.

FOR FURTHER INFORMATION CONTACT: Kyung Cho-Miller, Counsel, or Jane E. Ahrens, Senior Counsel, Division of Consumer and Community Affairs, at (202) 452-3667 or 452-2412; for the hearing impaired only, contact Janice Simms, Telecommunication Device for the Deaf, (202) 872-4984.

SUPPLEMENTARY INFORMATION:

I. Background

Much attention has been focused on "predatory lending practices" in connection with mortgage loans. The term encompasses a variety of practices. Homeowners in certain communities oftentimes are targeted with offers of high-cost credit, particularly the elderly, minorities, and women. In the case of elderly homeowners, they may be living on fixed incomes and have little or no home-secured debt. The loans may be based on consumers' equity in their homes and not their ability to make the scheduled payments. When homeowners have trouble repaying, they are often encouraged to refinance the loan into another unaffordable, high-fee loan that increases the loan amount owed primarily due to financed fees and decreases the consumers' equity in their homes. (This practice is referred to as "loan flipping" or "equity stripping.") The loan transactions also may involve fraud, misrepresentations, and other deceptive practices.

The Home Ownership and Equity Protection Act

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

HOEPA does not prohibit creditors from making any type of home-secured loan, nor does it limit or cap rates that creditors may charge. Instead, HOEPA identifies a class of high-cost mortgage loans through rate and fee triggers, and it provides consumers entering into these transactions with special protections. A loan is covered by HOEPA if (1) the APR exceeds the rate for Treasury securities with a comparable maturity by more than 10 percentage points, or (2) the points and fees paid by the consumer exceed the greater of 8 percent of the loan amount or $400. The $400 figure is adjusted annually based on the Consumer Price Index; for 2001 it is $465. 65 FR 70465, Nov. 24, 2000.

HOEPA is implemented in § 226.32 of the Board's Regulation Z, effective in October 1995. 60 FR 15463, March 24, 1995. HOEPA also amended TILA to require additional disclosures for reverse mortgages, that are contained in § 226.33 of Regulation Z. For purposes of this notice of proposed rulemaking, however, the term "HOEPA-covered loan" or "HOEPA loan" generally refers only to mortgages covered by § 226.32 that meet HOEPA's rate or fee-based triggers.

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

HOEPA also restricts certain loan terms based on evidence that they had been associated with abusive lending practices. These terms include short-term balloon notes, prepayment penalties, non-amortizing payment schedules, and higher interest rates upon default. Creditors are prohibited from engaging in a pattern or practice of making HOEPA loans without regard to the borrower's ability to repay the loan. HOEPA imposes a strict liability rule that holds purchasers and assignees, as well as creditors, liable for any violations of law. In addition, HOEPA authorizes the Board, under defined criteria, to prohibit specific acts or practices.

Continued Concerns About Predatory Lending Practices

Concerns about predatory lending practices persist, but information about predatory lending is essentially anecdotal. There are no precise data and no ready means for measuring its prevalence. Yet there have been sufficient reports of actual cases to indicate that a problem exists.

Since the enactment of HOEPA in 1994, the volume of home-equity lending has increased significantly in the subprime mortgage market. Based on data reported under the Home Mortgage Disclosure Act, 12 U.S.C. 2801 et seq., the number of subprime loans made by lenders that identify themselves primarily as subprime lenders increased about six times- from 138,000 in 1994 to roughly 856,000 in 1999. This growth in subprime lending has expanded the availability of home-secured credit for consumers having less-than-perfect credit histories and other consumers who do not meet the underwriting standards of prime lenders. On the other hand, because consumers who obtain subprime mortgage loans have, or may perceive they have, fewer credit options than other borrowers, they may be more vulnerable to unscrupulous lenders or brokers. There is concern that with the increase in the number of subprime loans, there has been a corresponding increase in the number of predatory loans.

In June 1997 the Board held hearings in Los Angeles, Atlanta, and Washington, D.C., pursuant to HOEPA's mandate that the Board periodically hold public hearings on home-equity lending and HOEPA. Participants were asked to address several topics, including the effect of HOEPA on homeowners seeking home-equity credit and on credit opportunities in the communities that had been targeted by unscrupulous lenders prior to HOEPA's enactment (for example, whether there had been changes to the volume or cost of home-equity installment loans); the effectiveness of the disclosures and suggestions for improvements; and whether any exemptions or prohibitions would be appropriate for the Board to consider under its HOEPA rulemaking authority. 62 FR 23189, April 29, 1997. Those testifying at the hearings were in general agreement that it was too soon after HOEPA's enactment to determine the effectiveness of the new law; however, consumer representatives reported continuing abusive practices by home-equity lenders against consumers of all degrees of sophistication.

The hearings formed the basis for a detailed analysis of the problem of abusive lending practices in mortgage lending contained in a July 1998 report to the Congress by the Board and the Department of Housing and Urban Development (HUD) on possible reforms to TILA and the Real Estate Settlement Procedures Act regarding mortgage-related disclosures. The 1998 report is posted at the Board's website: www.federalreserve.gov/boarddocs/press/general/1998. Chapter 6 of the report suggested a multifaceted approach to curbing predatory lending practices, including some legislative action, stronger enforcement of current laws, and nonregulatory strategies such as community outreach efforts and consumer education and counseling. See also Chapter 2 at page 17, Chapter 7 at page 76, and Appendix D.

Many initiatives to address predatory lending have been undertaken. Several bills have been introduced in the Congress, and several states have enacted or are considering legislation or regulations. The Board convened a federal task force of ten agencies and offices (the five agencies supervising depository institutions, the Federal Housing Finance Board, the Office of Federal Housing Enterprises Oversight, the Federal Trade Commission, the Department of Justice, and HUD) to attempt to establish a coordinated approach to deterring abusive and predatory practices and to enforcing existing laws that address them. HUD and the Department of Treasury ("Treasury') held five public forums on predatory lending this spring and issued a report in June 2000. The report contained legislative recommendations to the Congress and recommendations to the Board regarding the use of its regulatory authority to address predatory lending.

The Board held hearings last summer in Charlotte, Boston, Chicago, and San Francisco to consider approaches it might take in exercising regulatory authority under HOEPA. The hearings focused on expanding the scope of mortgage loans covered by HOEPA, prohibiting specific acts or practices, improving consumer disclosures, and educating consumers. In the notice announcing the hearings, the Board also solicited written comment on possible revisions to Regulation Z's HOEPA rules. 65 FR 45547, July 24, 2000 (hereinafter referred to as the July notice). The Board received approximately 450 comment letters. About two-thirds of the letters were general letters from consumers encouraging Board action to curb predatory lending. Of the letters that specifically addressed possible revisions under HOEPA, views representing the mortgage lending industry and consumer and community development interests were roughly even in numbers.

During the hearings and in the comment letters, most creditors and others involved in the mortgage lending industry opposed expanding the scope of mortgage loans covered by HOEPA. If the scope were to be broadened, however, many of these commenters preferred that the APR trigger be lowered but that the points and fees trigger remain unchanged. Creditors also urged the Board to act cautiously in crafting any new rules and stated that existing laws should be more vigorously enforced before additional regulation is considered. They expressed concern about the potential for reducing the availability of credit in the subprime market if more loans become subject to HOEPA and to additional restrictions.

Consumer representatives and community development organizations support revisions that would broaden HOEPA's scope. (Some believe that predatory lending is responsible for a substantial increase in foreclosures in certain communities.) They asked the Board to lower the APR trigger to the maximum extent possible, and to add a variety of costs to the points and fees tests, including lump-sum premiums for credit insurance and similar products, prepayment penalties, and lender-paid broker compensaion (yield spread premiums). They recommend that the Board ban certain acts or practices associated with predatory loans. They were particularly concerned about certain loan terms such as prepayment penalties and balloon payments, single-premium credit insurance, and "loan flipping." To address concerns about creditors that extend credit based on homeowner's equity without regard to repayment ability, consumer representatives and others asked the Board to require that consumers' income be verified. Additionally, some commenters suggested imposing a maximum debt-to-income ratio for determining whether creditors appropriately considered a consumer's repayment ability. Transcripts of the hearings can be accessed at http://www.federalreserve.gov/community.htm.

Although not specifically addressed in the Board's notice announcing the hearings on home-equity lending and possible revisions under HOEPA, commenters also recommended the following actions, among others: (1) under the Board's Regulation C (Home Mortgage Disclosure, 12 CFR Part 203), require additional information for certain home loans to be collected; (2) under interagency rules implementing the Community Reinvestment Act, 12 U.S.C. 2901 et seq., ensure that "predatory loans" by a financial institution or its affiliates cannot be used to demonstrate that the financial institution is meeting the credit needs of the community; and (3) under the Board's authority to monitor the activities of bank holding companies, examine nonbank subsidiaries that engage in subprime lending for compliance with consumer financial services and fair lending laws.

II. Summary of Proposal

The Board is proposing amendments to Regulation Z to address predatory lending and unfair practices in the home-equity market. Proposed revisions are issued pursuant to the Board's authority to adjust the APR trigger and add additional charges to the points and fees test. See 15 U.S.C. 1602(aa). Proposed revisions are also issued pursuant to the Board's authority under HOEPA to prohibit certain acts or practices affecting (1) mortgage loans if the Board finds the act or practice to be unfair, deceptive or designed to evade HOEPA, or (2) refinancings if the Board finds the act or practice to be associated with abusive lending or otherwise not in the interest of the borrower. 15 U.S.C. 1639(l)(2). Revisions are also proposed pursuant to section 105(a) of TILA to effectuate the purposes of TILA, to prevent circumvention or evasion, or to facilitate compliance. 15 U.S.C. 1604(a).

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

Under the proposal, the APR trigger would be adjusted from 10 percentage points to 8 percentage points above the rate for Treasury securities having a comparable maturity, the maximum amount that the trigger may be lowered by the Board. The fee-based trigger would be adjusted to include premiums paid at closing for optional credit life and disability insurance and other credit protection products.

The proposed amendments also address some "loan flipping" within the first twelve months of a HOEPA loan by prohibiting the creditor or assignee (or an affiliate) that is holding the loan from refinancing it unless the refinancing is in the borrower's interest. The proposal would also prohibit creditors in the first five years of a zero interest rate or other low-cost loan from replacing that loan with a higher-rate loan, unless the refinancing is in the interest of the borrower. The proposed rule would define "low-cost" loans differently for fixed-rate and variable-rate transactions. For fixed-rate transactions, a low-cost loan is one that carries a rate that is two percentage points or more below the yield on Treasury securities with a comparable maturity. For variable-rate transactions, a low-cost loan is one where the current rate is at least two percentage points below the index or formula used by the creditor for making rate adjustments. This rule is designed primarily to protect low-cost home loans offered through mortgage assistance programs that give low- and moderate-income borrowers the opportunity for homeownership.

Creditors would also be prohibited from including "payable on demand" or "call provisions" in HOEPA loans. The proposal seeks to prevent evasion of HOEPA by prohibiting creditors from representing that a mortgage loan is an open-end credit line if it does not meet Regulation Z's definition for open-end credit. (HOEPA covers only closed-end credit transactions.) For example, a high-cost mortgage could not be structured as a home-secured line of credit to evade HOEPA if there is no reasonable expectation that repeat transactions will occur under a reusable line of credit.

The proposal would seek to strengthen HOEPA's prohibition on loans based on homeowners' equity without regard to repayment ability. A rebuttable presumption would be created that the creditor has engaged in a pattern or practice of making HOEPA loans based on homeowners' equity without regard to repayment ability, if a creditor does not document and verify consumers' repayment ability. Regarding disclosures, the proposal would revise the HOEPA disclosures to alert consumers in advance of loan closing that the total amount borrowed may be substantially higher than the amount requested due to the financing of insurance, points, and fees.

III. Section-by-Section Analysis of Proposed Rule

Subpart A – General

Section 226.1 – Authority, purpose, coverage, organization, enforcement, and liability.

Section 226.1(b) on the purpose of the regulation would be revised to reflect the addition of prohibited acts and practices in connection with credit secured by a consumer's dwelling. Section 226.1(d) on the organization of the regulation would be revised to reflect the restructuring of Subpart E (rules for certain home mortgage transactions).

Subpart C — Closed-end Credit

Section 226.23 – Right of Rescission

23(a) Consumer's Right to Rescind

Under section 125 of TILA, consumers have the right to rescind certain home-secured loans for three business days after becoming obligated on the debt. The right of rescission was created to allow consumers time to reexamine their credit contracts and cost disclosures and to reconsider whether they want to place their home at risk by offering it as security for credit.

If the required rescission notice or the "material disclosures" required by TILA are not delivered or are inaccurate, a consumer's right to rescind may extend beyond the three business days, for up to three years. For HOEPA-covered loans, the term "material disclosures" includes disclosures required to be given three days before consummation. Section 129(j) of TILA also provides that any mortgage that contains a provision prohibited by HOEPA is also deemed to be a failure to deliver material disclosures. The loan provisions prohibited by HOEPA are currently listed in § 226.32(d) of the regulation, and a reference to those provisions is included in footnote 48 to § 226.23(a)(3).

As discussed below, the Board is proposing to use its authority under HOEPA to prohibit certain acts or practices. The new prohibitions would affect the ability of creditors to include certain provisions in loans covered by HOEPA. These provisions would be contained in proposed § 226.34. Accordingly, the proposed rule would also amend footnote 48 to § 226.23(a)(3) to include a reference to § 226.34.

Subpart E — Special Rules for Certain Home Mortgage Transactions

Section 226.31 — General Rules

<u>31(c) Timing of Disclosures</u>
<u>31(c)(1)(i) Change in Terms</u>

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

Based on hearing testimony, it appears that some creditors offer credit insurance and other optional products at loan closing. If the consumer finances the purchase of such products and as a result the monthly payment differs from what was previously disclosed under § 226.32, the terms of the extension of credit have changed; redisclosure is required and a new three-day waiting period applies. Comment § 226.31(c)(1)(i)-2 would be added to clarify this redisclosure requirement. <u>See</u> discussion below concerning § 226.32(c)(3) on when optional items may be included in the regular payment disclosure.

Section 226.32 — Requirements for Certain Closed-end Home Mortgages

<u>32(a) Coverage</u>

HOEPA covers mortgage loans that meet one of the act's two "high-cost" triggers –a rate trigger and a points and fees trigger. Under the proposed rule, both triggers would be extended to cover more loans.

<u>APR Trigger</u> -- Currently, a loan is covered by HOEPA if the APR exceeds by more than 10 percentage points the rate for Treasury securities with a comparable maturity. Section

103(aa) of TILA authorizes the Board to adjust the APR trigger by 2 percentage points from the current standard of 10 percentage points above Treasury securities with comparable maturities, upon a determination that the adjustment is consistent with the consumer protections against abusive lending contained in HOEPA and is warranted by the need for credit.

In the July notice, the Board invited comment on whether lowering the APR trigger to 8 percentage points would be effective in furthering the purposes of HOEPA. Comment was also solicited on whether such action would have any significant impact on the availability or cost of subprime mortgage loans.

Consumer representatives and community development organizations recommended lowering the APR trigger to 8 percent to extend HOEPA's protections to a broader class of transactions. Many stated that under the current 10 percent test, few subprime loans are covered by HOEPA. They believed that lowering the APR trigger by 2 percentage points would not affect credit availability. A number of these commenters suggested even further adjustments by the Congress.

Creditors that make subprime loans were generally opposed to broadening HOEPA's scope. Some believed that lowering the APR trigger will not curb the actions of unscrupulous lenders. Some stated that if the Board were to broaden the category of loans subject to HOEPA, lowering the APR trigger would be more consistent with the purpose of HOEPA than including additional costs in the points and fees test.

Based on an analysis of hearing testimony, written comments received, and other information, and pursuant to its authority under section 103(aa) of TILA, the Board is proposing to revise § 226.32(a)(1)(i) to lower the APR trigger to 8 percentage points. With this change, based on current rates for Treasury securities, loans with an APR of approximately 14 percent or higher would be subject to HOEPA.

Data are not available on the number of home-equity loans currently subject to HOEPA, or the number of loans that would be covered if the APR trigger were lowered. Data compiled by the Office of Thrift Supervision reflects that based on interest rate alone, if the HOEPA rate trigger were lowered by 2 percentage points, HOEPA's coverage would expand from approximately 1 percent to 5 percent of subprime mortgage loans. These numbers omit the other costs included in the APR trigger, such as points and brokers fees; if those costs were included the number of HOEPA-covered loans would be larger.

If HOEPA's rate trigger were lowered, more consumers with high-cost loans would receive HOEPA disclosures and would be covered by HOEPA's prohibitions against loan terms such as non-amortizing payment schedules, balloon payments on short-term loans, or interest rates that increase upon default. More loans would be subject to the rule against unaffordable lending. A creditor's ability to impose prepayment penalties would also be restricted in most cases. In addition, more high-cost loans would be subject to HOEPA's strict liability rule that holds purchasers and assignees, as well as creditors, liable for any violations of law.

Some subprime lenders do not make HOEPA loans due to their concerns about compliance burdens, potential liability, and reputational risks. They believe that expanding HOEPA's coverage will reduce credit availability. The extent to which lowering the HOEPA

APR trigger may affect the availability of credit is difficult to ascertain. Some creditors who do not make HOEPA loans may withdraw from making loans in the range of rates that would be covered by the expanded triggers. Other creditors may fill any void left by creditors that choose not to make HOEPA loans. And others may have the flexibility to lower rates or fees for some loans to avoid HOEPA's coverage.

The subprime lending market has grown substantially and has increased the availability of credit to borrowers having less-than-perfect credit histories and other consumers who are underserved by prime lenders. A borrower does not benefit from this expanded access to credit if the credit is offered on unfair terms or involves predatory practices. Because consumers who obtain subprime mortgage loans have fewer credit options than other borrowers, or because they perceive that they have fewer options, they may be more vulnerable to unscrupulous lenders or brokers. The proposed revisions are intended to ensure that the need for credit by subprime borrowers will be fulfilled more often by loans that are subject to HOEPA's protections against predatory practices. To avoid coverage by the HOEPA rules, some creditors may choose not to make loans covered by the revised rate triggers but there is no evidence to date that the impact on credit availability would be significant.

APR trigger based on lien status -- When a consumer seeks a loan to consolidate debts or finance home repairs, some creditors may require consumers to borrow additional funds to pay off the existing first mortgage as a condition of providing the loan. This ensures that the creditor will be the senior lien-holder, but also will increase, perhaps significantly, the points and fees paid for the new loan. In addition, the existing first mortgage may have been at a lower rate. Some commenters, including creditors and consumer groups, suggested a two-tiered APR trigger, to encourage creditors to offer subordinate-lien mortgages rather than to refinance existing mortgages to obtain a first-lien position. To illustrate, the APR trigger for first-lien mortgages could be lowered to 8 percentage points above Treasury securities with comparable maturities, and the APR trigger for subordinate-lien mortgages could remain unchanged at 10 percentage points. The Board requests comments on this approach, including the benefits and compliance burdens associated with this approach to adjusting the APR trigger.

32(b) Definition

Points and fees test -- The fee-based trigger is met if the points and fees payable by the consumer at or before loan closing exceed the greater of 8 percent of the total loan amount or $451 ($465 for 2001). Except for interest, "points and fees" cover all finance charges (including brokers' fees). The act specifically excludes reasonable closing costs that are paid to unaffiliated third parties. HOEPA also authorizes the Board to add "such other charges" to the points and fees test as the Board deems appropriate. The proposed rule would expand the points and fees test to include amounts paid at or before closing for optional credit life, accident, health, or loss-of-income insurance and other credit-protection products such as debt-cancellation coverage.

The Board requested comment on the merits of including the following fees in the points and fees test: (1) lump-sum premiums for optional credit life insurance or similar products collected at closing; (2) prepayment penalties (assessed on the original loan) when the loan is refinanced with the same creditor or an affiliate; and (3) points paid by the consumer for the existing loan when the same creditor (or an affiliate) refinances the loan within a specified time period. The Board also solicited comment on whether a better approach would be to recommend a statutory amendment that would include all closing costs in the points and fees test.

Premiums for credit insurance, disability insurance, and similar products --

Concerns have been raised about high-pressure sales tactics associated with single-premium credit life insurance and "insurance packing," where creditors automatically include the insurance in the loan amount without the consumer's request. As a result, consumers may perceive that the insurance is a required part of the loan. Consumer advocates assert that because these premiums are excluded from the finance charge (and thus excluded from HOEPA's triggers), predatory lenders may avoid HOEPA coverage by "packing" loans with high-priced credit insurance that represents a significant source of fee income, in lieu of charging fees that would be included under the current HOEPA trigger.

On the other hand, industry commenters have argued that optional credit insurance should not be considered a cost of the loan, and therefore should not be included in the HOEPA fee trigger. Because the cost of credit insurance is significant, some of these commenters assert that many mortgage loans with single-premium credit insurance could become HOEPA loans, regardless of the interest rate or points charged on the loan. They noted that creditors might cease offering single-premium credit insurance to avoid HOEPA's coverage.

To the extent that some creditors choose not to offer single-premium policies, consumer advocates note that credit insurance could be made available through other vehicles--for example, policies that collect premiums monthly based on the outstanding loan balance. Industry commenters responded that some borrowers find it more affordable to finance a single-premium policy over the full loan term rather than paying premiums monthly during the shorter term of the insurance policy, which is typically 60 months or less.

Section 103(aa) of TILA defines "points and fees" for purposes of HOEPA to include all items included in the finance charge except interest or the time-price differential. Under section 106 of TILA premiums for optional credit insurance are treated as finance charges, unless certain disclosures are provided to consumers. The Board may also include charges other than finance charges in HOEPA's fee-based trigger, if it determines that their inclusion would be appropriate. The legislative history of HOEPA specifically suggests that the Board might consider including the cost of credit insurance premiums in the HOEPA calculation.

The Board believes that including optional single-premium insurance and other credit protection products in the HOEPA points and fees trigger is appropriate when the amounts are paid by the consumer at or before closing. The creditor or the credit account is the beneficiary and the cost of the insurance may represent a significant cost of the credit transaction. In addition, creditors receive significant commissions for selling credit insurance. Moreover, including optional credit insurance and similar products in the points and fees test would prevent a creditor from evading HOEPA by packing a loan with such products in lieu of charging fees that would be included under the current HOEPA trigger.

Section 226.32(b)(1) would be revised to include in the points and fees test, the cost of premiums or other charges for credit life, accident, health, or loss-of-income insurance, debt-cancellation coverage (whether or not the debt-cancellation coverage is insurance under applicable law), or similar products paid by a borrower at or before closing. (Premiums paid for required credit insurance policies are considered finance charges and are already included in the points and fees trigger.) Under the proposal, premiums paid at or before closing for credit insurance are included whether they are paid in cash or financed, and whether the amount represents the entire premium for the coverage or an initial payment. Proposed comment 32(b)(1)(iv)-1 contains this guidance.

A mortgage loan is covered by HOEPA if the "points and fees" exceed 8 percent of the "total loan amount." The total loan amount is based on the "amount financed" as provided in §226.18(b). Comment 32(a)(1)(ii)-1 discusses the calculation of the total loan amount. The comment would be revised to illustrate that premiums for credit life, accident, health, loss-of-income, debt cancellation coverage, or similar products that are financed by the creditor must be deducted from the amount financed in calculating the total loan amount.

Conditional inclusion of insurance and other credit protection products -- Comment is solicited on whether exclusion of the optional premiums from the points and fees test would be warranted under some circumstances. Charges for optional insurance and similar products are finance charges under the TILA unless certain disclosures are provided to consumers. Would a similar approach be appropriate in connection with the points and fees trigger under HOEPA? For example, credit insurance or debt protection coverage might be excluded from the points and fees test based on the consumer's ability to cancel the coverage and obtain a full refund, where the consumer is also provided with adequate information about their rights after the loan closing.

Additional data -- The Board seeks information about any further studies or data pertaining to subprime lending or HOEPA loans that would be useful in determining the effect of the proposal adjusting the HOEPA rate and fee triggers. Other data or studies relevant to the proposal, about subprime lending generally, and HOEPA loans in particular, are also requested.

Other fees -- The Board is not proposing to include any other charges in the points and fees test at this time. Some commenters supported the inclusion of lender paid broker compensation (yield spread premiums) which are paid indirectly by the borrower in the form of a higher interest rate. It is not clear that an amount paid over the life of the loan and included in HOEPA's APR trigger should also be included in the points and fees trigger as an amount paid at or before closing. Consumer representatives and others believed that prepayment penalties and points paid on an existing loan should be included in the points and fees test when the loan is refinanced by the same creditor or an affiliate, to expand HOEPA to more transactions. Many industry representatives opposed this approach. It is not clear that it is appropriate to include as part of a new loan, for purposes of the HOEPA fee trigger, fees paid in connection with an earlier transaction.

Views were mixed on whether the Board should recommend a statutory amendment to TILA that would include all closing costs in the points and fees test. Some commenters generally supported including closing costs typically charged by third parties; others believed that creditors may not be aware of costs charged to consumers by third parties and therefore should not be held accountable for including such costs in the points and fees calculation. One trade association representing creditors supported the recommendation as a part of any legislative reformation of existing consumer protection laws affecting mortgage lending.

<u>32(c) Disclosures</u>

Section 129(a) of TILA requires creditors offering HOEPA loans to provide abbreviated disclosures to consumers at least three days before the loan is closed, in addition to the disclosures generally required by TILA at or before closing. The HOEPA disclosures inform consumers that they are not obligated to complete the transaction and could lose their home if they obtain the loan and fail to make payments. The HOEPA disclosures also include a few key cost disclosures, such as the APR and the monthly payment (including the maximum payment for variable-rate loans and any balloon payment).

In the July notice, the Board requested comment on whether these disclosures could be improved. The Board referred to the Board and HUD's 1998 report to the Congress, where the agencies recommended adding references to the availability of credit counseling and requiring the consumer's monthly income to be stated in close proximity to the consumer's monthly payment. The Board asked specifically about the effect of adding to the HOEPA disclosures the total amount borrowed, to alert consumers to the fact that additional costs may have been included in the loan amount.

Creditors and consumer representatives question the benefit of requiring additional HOEPA disclosures to combat predatory lending. In addition, consumer representatives stated their preference for the Board to use its rulewriting authority to prohibit specific acts associated with predatory lending rather than to require additional disclosures. Industry commenters expressed concern about additional disclosures that might increase compliance costs without a commensurate benefit to consumers.

The Board believes, however, that an additional disclosure might be in the interest of borrowers. Pursuant to its authority under section 129(l)(2)(B) of TILA, the Board is proposing to add a disclosure for refinancings subject to HOEPA in § 226.32(c)(5).

<u>32(c)(3) Regular Payment</u>

Comment 32(c)(3)-1 would be revised for clarity. The rule allows creditors to include voluntary items in the regular payment disclosed under § 226.32 only if the consumer has previously agreed to such items. Comment is solicited on whether consumers should be required to request or affirmatively agree to purchase voluntary items in writing, to aid in enforcing the rule. Testimony and comments suggest that some consumers do not agree to the insurance in advance of closing although the HOEPA disclosures provided in advance of closing may already include insurance premiums in the monthly payment.

Section 226.32(c)(3) requires creditors to disclose to consumers the amount of the regular monthly (or other periodic) payment. Comment 32(c)(3)-2 requires creditors to disclose any balloon payment along with the regular periodic payment. Under the proposal, the disclosure requirement for the amount of the balloon payment would be moved from the commentary to the regulation, to aid in compliance. Also, Model Sample H-16, which illustrates the disclosures required under § 226.32(c), would be revised to include a model clause on balloon payments.

32(c)(5) Amount Borrowed

Under the proposal, § 226.32(c)(5) would be added to require disclosure of the total amount the consumer will borrow, as reflected by the face amount of the note. Adding the total amount borrowed is intended to alert consumers in advance of the loan closing that the amount of the loan may be substantially higher than requested due to the financing of points, fees, and insurance. Consumers and consumer representatives note that consumers often seek a modest loan amount for medical or home improvement costs, only to discover at closing (or thereafter) that the note amount is substantially higher, due to fees and insurance premiums that are financed along with the requested loan amount. This disclosure may help some consumers avoid entering into unaffordable loans.

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

Counseling

Both consumer and creditor commenters acknowledged the benefits of pre-loan counseling as a means to counteract predatory lending. There was uniform concern, however, about requiring a referral to counseling for HOEPA loans because the actual availability of local counselors may be uncertain. The Board requests comment on whether a generic disclosure advising consumers to seek independent advice might encourage borrowers to seek credit counseling.

32(d) Limitations
32(d)(1) Balloon Payment

Section 129(e) of TILA prohibits balloon payments for loans covered by § 226.32 that have terms of less than five years. In the July notice, the Board noted that lenders that price their loans just below HOEPA's triggers might include balloon payments that force consumers to refinance the loan and pay additional points and fees. The Board requested comment on any restrictions or additional disclosures that might be appropriate in connection with balloon payments in order to prevent abusive practices.

Consumer representatives and others asked the Board to ban balloon payments for all HOEPA loans. They contend that consumers are just as unlikely to repay or refinance the loan on more affordable terms after five years than they are after two or three years. Creditors were generally opposed to adding restrictions for balloon payments beyond those currently in HOEPA. They believe that balloon notes can be as beneficial to consumers obtaining HOEPA loans, as they may be for other borrowers. Because HOEPA limits the prohibition on balloon payments to loans shorter than five years, the Board does not believe it is appropriate to impose restrictions on longer term loans without evidence of a particular problem related to longer term balloon notes. The Board proposes to provide additional guidance on disclosing balloon payments where they are permitted under HOEPA. See § 226.32(c)(3) and Model Sample H-16.

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

Balloon notes in loans shorter than five years are prohibited by HOEPA to prevent a creditor from forcing a consumer to refinance a loan and pay additional points and fees. The same concerns would be raised if a creditor could force the consumer to refinance by reserving the right to call the loan at any time and then demanding payment of the entire outstanding balance. Pursuant to the Board's authority under section 129(l)(2)(A), "payable on demand" or "call" provisions for HOEPA loans would be prohibited under § 226.32(d)(8), unless the clause is exercised in connection with a consumer's default. Although these terms currently do not appear to be widely used in HOEPA loans, demand clauses raise the same concerns as balloon notes. Moreover, TILA has a similar prohibition for home-secured lines of credit. Proposed commentary to § 226.32(d)(8) would provide guidance similar to the guidance to creditors offering home-equity lines of credit.

The Board requested comment in the July notice on the merits of prohibiting "due on demand" clauses for loans covered by § 226.32 unless such a clause is exercised in connection with a consumer's default. Creditors and consumer representatives that commented generally supported such a prohibition, although some creditors suggested that, similar to balloon notes, the prohibition be limited to loans with terms of less than five years.

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

Section 129(l) of TILA authorizes the Board to prohibit specific acts or practices to curb abusive lending practices. The act provides that the Board shall prohibit practices: (1) in connection with all mortgage loans, if the Board finds the practice to be unfair, deceptive, or designed to evade HOEPA; and (2) in connection with refinancings of mortgage loans, if the Board finds that the practice is associated with abusive lending practices or otherwise not in the interest of the borrower. The Board has not previously exercised this authority.

The July notice requested comment on specific approaches to deal with predatory lending practices, both regulatory and legislative, and whether any new requirements or prohibitions should apply to all mortgage transactions, only to refinancings, or only to HOEPA-covered refinancings. Specific questions were posed about credit insurance, unaffordable lending, balloon payments, consolidation loans, prepayment penalties, foreclosure notices, misrepresentation about a borrower' qualifications, reporting borrowers' payment history, credit counseling, and disclosures. Consumer representatives, community organizations, and others offered numerous recommendations. Industry commenters generally opposed any new rules based on the view that better enforcement of existing law would be sufficient to address concerns about predatory lending.

HUD and Treasury held five public forums on predatory lending this spring and issued a report in June 2000. The report contained legislative recommendations to the Congress and recommendations to the Board regarding the use of its regulatory authority to address predatory lending. HUD and Treasury recommended rules to address "loan flipping" and fraudulent acts or practices, unaffordable lending, and the sale of single-premium credit insurance products.

Based on the written comments received, testimony provided at Board hearings on home-equity lending, and other information, the Board proposes to prohibit certain acts or practices that are deemed to be unfair, deceptive, designed to evade the provisions of section 129 of the TILA, associated with abusive lending practices, or otherwise not in the interest of the borrower in connection with mortgage loans, as described below. The rules are intended to target unfair or abusive lending practices without unduly interfering with the flow of credit, creating unnecessary credit burden, or narrowing consumers' options in legitimate transactions.

Organization of § 226.34

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

34(a) Prohibited acts or practices for loans subject to § 226.32
34(a)(1) Home improvement contracts

Section 226.32(e)(2) regarding home-improvement contracts would be renumbered as § 226.34(a)(1) without substantive change.

34(a)(2) Notice to Assignee

Section 226.32 (e)(3) regarding assignee liability for claims and defenses consumers may have in connection with HOEPA loans would be renumbered as § 226.34(a)(2).

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

34(a)(3) Refinancings Within Twelve-month Period

"Loan flipping" refers to the practice by brokers and creditors of frequently refinancing home-secured loans to generate additional fee income even though the refinancing is not in the borrower's interest. Loan flipping is among the most flagrant of lending abuses. Victims tend to be borrowers who are having difficulty repaying a high-cost loan. The creditor holding the loan promises to refinance the loan on more affordable loan terms. The creditor relies on the consumer's remaining home equity to support the new, larger loan and to finance additional fees, sometimes without regard to the consumer's ability to make the new scheduled payments. These loans typically provide little benefit to the borrower because the loan amount increases mostly to cover fees and there may be no significant reduction in the interest rate. As a result, the monthly payment may increase, making the loan even more unaffordable.

In assessing possible approaches to address loan flipping, the Board has considered rules that would (1) be effective in curbing detrimental refinancings without limiting consumer choice in legitimate credit transactions, and (2) provide clear guidance to creditors on what acts or practices are prohibited.

The Board has received many suggestions on how it might address loan flipping. Those suggestions generally fall into two categories: (1) limiting fees to a specified percentage of the total loan amount, requiring that fees be charged solely on any additional funds being borrowed, or generally restricting fees on refinancings; and (2) prohibiting refinancings that do not provide a "tangible benefit" to borrowers. While loan flipping occurs in both HOEPA and non-HOEPA loans, the Board believes that any rule restricting refinancings to address loan flipping could be overly broad if it is not limited to HOEPA loans.

Limiting the amount of fees charged on a refinancing would reduce the economic incentive for creditors to flip loans, and thus would be the most direct way to curb loan flipping. While the Board has broad authority under HOEPA to prohibit specific acts and practices for all mortgage loans, it is questionable whether this authority includes restricting loan fees by capping them. Moreover, there are no clear standards for determining an appropriate level of fees. A rule permitting creditors to charge fees only on additional funds being borrowed could be effective only if the amount of fees is also capped, because creditors could impose fees that are excessive in relation to the new amount borrowed.

A rule prohibiting outright the imposition of upfront fees on a refinancing would remove the economic incentive for loan flipping (as the loan costs would be built into the interest rate and there would be no immediate benefit to the broker or creditor). But such a rule could unduly limit consumer choice in legitimate transactions. Some consumers may prefer to pay points to buy down the rate. Others may not qualify for monthly payments at a higher interest rate. Moreover, a ban on all up front fees, in conjunction with the current HOEPA restriction on prepayment penalties could prevent creditors from recovering their origination costs if the loan is paid off early; creditors would have to charge interest rates that are adequate to cover potential losses due to prepayments.

Under the second approach, setting a "tangible benefit" test, loan flipping would be addressed by prohibiting refinancings of HOEPA loans that do not provide benefit to the borrower or are not in the borrower's interest. This approach seeks to ensure that the borrower obtains benefits from the refinancing that would justify the additional costs. Because the rule is subjective, however, it does not provide creditors with clear guidance on what transactions are permitted. Without adequate guidance, it would be up to the courts to construe what constitutes a sufficient benefit on a case-by-case basis. This could affect the willingness of some creditors to refinance HOEPA loans.

Pursuant to its authority under section 129(l)(2)(B), the Board is proposing a rule based on a narrower benefits test that would only apply for a twelve month period. A creditor or assignee (or an affiliate) holding a HOEPA loan would be prohibited from refinancing it within the first twelve months unless the refinancing is in the borrower's interest. Anecdotal evidence suggests that creditors frequently flip loans by pressuring their existing customers who may be having difficulty making payments on their current mortgage. This more narrowly tailored rule should prevent abuses in the most egregious cases, where creditors or brokers flip loans shortly after loan consummation. Even under this approach, there is some uncertainty about what constitutes a benefit; however, the advantage of the rule in preventing loan flipping in the clearest cases of abuse seems to outweigh the effect of creating some uncertainty in marginal cases. The determination of whether or not a benefit exists would be based on the totality of the circumstances. For example, consideration should be given to the amount of any new funds advanced in comparison to the total loan charges on the refinancing (which may be based predominately on the pre-existing loan balance). Proposed comment 34(a)(3)-1 would provide guidance on this standard.

The proposed rule in § 226.34(a)(3) would not prevent a consumer from seeking a refinancing from another lender. Creditors would also be prohibited from engaging in acts or practices designed to evade the rule. For example, a creditor that arranged refinancings of its own loans with an unaffiliated creditor would be deemed to be seeking to evade the rule. Similarly, a creditor would be deemed to be seeking to evade the rule if the creditor modified the existing loan agreement (but did not replace the existing loan with the new loan) and charged a fee.

34(a)(4) Repayment Ability
34(a)(4)(i)

Under section 129(h) of TILA, a creditor may not engage in a pattern or practice of making HOEPA loans based on the equity in the borrower’s home without regard to the consumer's repayment ability, including the consumer's current and expected income, current obligations, and employment status. The rule currently in § 226.32(e)(1) would be moved to § 226.34(a)(4)(i) and revised to parallel the statutory language.

Comment 32(e)(1)-1 on determining repayment ability would be renumbered as comment 34(a)(4)(i)-1, and modified to address proposed documentation and verification requirements below.

Pattern or Practice -- Section 129(h) of TILA does not define “pattern or practice,” nor does the legislative history provide any guidance as to how the phrase should be applied. In the July notice, the Board solicited comment on whether additional interpretive guidance on the “pattern or practice” requirement would be useful, or whether case-by-case determinations are more appropriate. Comment was also solicited on whether, if additional guidance would be useful, what elements of the requirement should the guidance address.

Some commenters believe guidance is not needed and a case-by-case approach is sufficient. Industry commenters requested that the pattern and practice standard be quantified. Consumer representatives suggested that the Board adopt the standard applied in cases under civil rights and fair lending laws.

Proposed comment 34(a)(4)(i)-2 provides that determining whether a pattern or practice exists depends on the totality of the circumstances and cites various statutes that may be helpful in analyzing factors that are relevant to a pattern or practice determination. The proposed comment does not identify individual factors raised in the case law, given the fact-specific nature of a pattern or practice determination.

Discounted Introductory Rates -- Concern has been raised about creditors determining a consumer’s repayment ability based on low introductory rates offered under some variable-rate programs. Comment 34(a)(4)(i)-3 would be added to provide that in transactions where the creditor sets the initial interest rate and the rate is later adjusted (whether fixed or later determined by an index or formula), in considering consumers' repayment ability, the creditor must consider increases to the consumer's payments assuming the maximum possible increases in rates in the shortest possible time frame.

34(a)(4)(ii)

Currently compliance with the prohibition against unaffordable lending is difficult to enforce because creditors may not be able to show how they considered the consumer's ability to repay. In addition, there have been reports of creditors relying on inaccurate information provided by unscrupulous loan brokers.

In the July notice, the Board invited comment on what standards the Board might adopt for determining whether a creditor has considered the consumer's ability to repay. Some commenters suggested that creditors be required to document and verify the basis for the creditor's consideration of the consumers' repayment ability. Many creditors stated that they routinely document and verify financial information. Commenters also suggested that creditors be prohibited from extending credit where the borrower's monthly debt-to-income ratio exceeds 50 percent, except perhaps in the case of high-income borrowers. However, there is no clear standard for an appropriate debt-to-income ratio, which may vary depending on a particular borrower's circumstance.

Proposed § 226.34(a)(4)(ii) would be added to require that creditors generally document and verify consumers' current or expected income, current obligations, and employment to the extent applicable. If a creditor engages in a pattern or practice of making loans without documenting and verifying consumers' repayment ability, there would be a presumption that the creditor has violated the rule. For borrowers who are self-employed, the verification rules would be more flexible. A creditor may rely on tax returns or any other source that provides the creditor with a reasonable basis for believing that the income exists and will support the loan. Proposed comment 34(a)(4)(ii)-1 contains this guidance.

34(b) Prohibited Acts or Practices for Dwelling-secured Loans
34(b)(1) Limitations on Refinancing Certain Low-rate Loans

When a consumer seeks a second mortgage to consolidate debts or to finance home improvements, some creditors also require the existing first mortgage to be paid off as a condition of providing the new funds. This ensures that the creditor will be the senior lien-holder, but may increase significantly the points and fees paid for the new loan. In the July notice of the hearings, the Board solicited comment on whether regulatory action is appropriate to protect consumers from abuses and, if so, what type of action could be taken without restricting credit in legitimate transactions?

Industry commenters stated that there is nothing inherently abusive about refinancing an existing first-lien mortgage loan when the creditor provides new funds, for example, to consolidate debt. To address any concerns, one trade association suggested requiring a disclosure reminding borrowers that funds are being borrowed to pay off the prior loan and that points and fees are charged on the total amount of the new financing. In response to creditors who will only make loans if they have first-lien priority, they noted that the mortgagee will often allow subordination of their security interest to lenders when the borrower seeks a second loan.

Hearing testimony reflects abuses in connection with the refinancing of loans that were made through mortgage assistance programs designed to give low- or moderate-income borrowers the opportunity for homeownership. Some of these homeowners who have unsecured debits have been targeted by unscrupulous lenders who consolidate the debts and replace the low-cost first-lien mortgage with a substantially higher cost loan. The replacement loans are often unaffordable, may involve "loan flipping" and, as a result, homeowners have lost their homes. In some cases, the low-cost loan is replaced even though the first-lien holder may be willing to subordinate its security interest. Where subordination does not occur, it might be more beneficial for the borrower to keep the original low-rate mortgage loan and obtain a second mortgage, if that option is available.

Pursuant to the Board's authority under section 129(l)(2)(B), to protect against abusive refinancings, the Board is proposing a rule that would prohibit creditors in the first five years of a zero interest rate or other low-cost loan from replacing that loan with a higher-rate loan, unless the refinancing is in the interest of the borrower. The proposed rule would define "low-cost" loans differently for fixed-rate and variable-rate transactions. For fixed-rate transactions, a low cost loan is one that carries an interest rate that is two percentage points or more below the yield on Treasury securities with a comparable maturity. For variable-rate transactions, a low-cost loan is one where the current interest rate is at least two percentage points below the index or formula used by the creditor for making rate adjustments. This rule, contained in § 226.34(b)(1), is designed primarily to protect low-cost, home loans offered through mortgage assistance programs that give low- and moderate-income borrowers the opportunity for homeownership. Proposed comment 34(b)(1)-1 would be added to provide that creditors may rely on a statement by the borrower regarding the current rate of interest on their existing loan.

34(b)(2) Open-end Credit

HOEPA covers only closed-end loans. If a consumer obtains a home-secured line of credit ("open-end") with an APR or points and fees above HOEPA's rate and fee triggers, the loan is not subject to HOEPA's disclosure requirements or limitations. In the July notice, the Board solicited comment on the extent to which creditors may be using open-end credit lines to evade HOEPA. The FTC has brought two enforcement actions to prevent creditors from evading HOEPA in this manner. See FTC v. CLS Fin. Services, Inc., No. C99-1215Z (W.D. Wash. July 30, 1999); FTC v. Wasatch Credit Corp., No. 2-99CV579G (D. Utah Aug. 3, 1999).

Consumer representatives and others generally believe that HOEPA should cover home-secured lines of credit ("open-end credit"). If open-end credit is not covered under HOEPA, they support explicit rules to ban the use of open-end credit to evade HOEPA. Some consumer representatives at the Board's hearings reported cases where consumers applied for a closed-end home-secured loan but learned for the first time at closing that the loan documents were structured as open-end credit, with credit limits far in excess of the amount requested. Some consumer advocates have reported cases where creditors have documented loans as open-end "revolving" credit, even if there was no expectation of repeat transactions under a reusable line of credit. Some of the cases reported by consumer advocates involved loans with high rates and fees that exceeded HOEPA's price triggers for closed-end loans.

Industry commenters opposed any rules for open-end credit. They believe there is insufficient evidence that creditors are using open-end credit to evade HOEPA. Some commenters stated that additional rules are unnecessary because it is currently a violation of TILA to provide disclosures for an open-end credit plan if the legal obligation does not meet the criteria for open-end credit.

Where a loan is documented as open-end credit but the features and terms demonstrate that it does not meet the definition of open-end credit, the loan is subject to the rules for closed-end credit, including HOEPA if the rate or fee trigger is met. Pursuant to its authority under section 129(2)(A), under § 226.34(b)(2), the Board is proposing a rule to clarify this point and apply HOEPA's remedies to such cases.

The Board is also soliciting comment on the need and feasibility of rules to prevent evasions of HOEPA in other circumstances. For example, should there be a rebuttable presumption that a creditor intended to evade HOEPA, in violation of the law, if a consumer applies for a closed-end home-secured loan but receives an open-end line of credit that is priced above HOEPA's triggers.

Appendix H to Part 226 – Closed-end Model Forms and Clauses

Model Form H-16—Mortgage Sample illustrates the disclosures required by § 226.32(c), which must be provided to consumers at least three days before becoming obligated on a mortgage transaction subject to § 226.32. Under the proposal, Model Form H-16 would be amended to illustrate the additional disclosures required for refinancings proposed at § 226.32(c)(5). The Sample also includes an illustration for loans with balloon payments. A new comment app. H-20 would clarify that although the additional proposed disclosure is required for refinancings that are subject to § 226.32, creditors may, at their option, include this disclosure for any loan subject to that section.

Other Matters

Credit Insurance -- Some commenters urged the Board to (1) prohibit the financing of single premium credit insurance, or (2) delay the sale of credit insurance until after the loan is closed. The regulation of insurance has historically been a matter of state law. Under the McCarran-Ferguson Act, 15 U.S.C. 1012, unless a federal statute specifically relates to the business of insurance, it may not be construed to invalidate, impair, or supercede any state law enacted for the purpose of regulating the business of insurance. It is not clear the extent to which rules issued by the Board under HOEPA that seek to prohibit or regulate the sale of single premium credit insurance would be consistent with that standard.

In its July 1998 report to Congress on mortgage disclosure reform, the Board and HUD suggested that Congress consider whether adequate consumer protections currently exist. The report discussed possible approaches to regulating the sales of credit insurance in connection with mortgage loans to prevent abusive practices. The Congress might consider regulating the use of single-premium credit insurance policies in connection with HOEPA loans or other transactions.

Foreclosure Notice -- State law and local practice generally govern the procedures followed for foreclosures. Most states require direct notice to the consumer but, in a few states, notice by publication is legally sufficient. Even when consumers do receive direct notice, they may not be aware of their legal options.

In the July notice, the Board solicited comment on whether it should set minimum federal standards for foreclosure involving a consumer's primary dwelling. Some commenters supported minimum foreclosure standards, citing statistics showing an increase in foreclosures of subprime loans. Some consumer representatives believe that consumers should be provided with a substantive right to cure the foreclosure. Industry commenters believed federal standards are unnecessary. Other commenters stated that state law generally governs property and foreclosure law, and that the Congress is the better forum to establish a federal minimum standard for notices.

The Board is not proposing rules governing foreclosure notices at this time. The process of determining ownership rights in real property is historically left to the states. It is unclear whether HOEPA was intended to effect a change in the relationship between state and federal law. HOEPA's legislative history does not directly address the issue of foreclosure.

In a 1998 joint report to Congress on mortgage disclosure reform, the Board and HUD recommended that Congress consider the adoption of certain minimum standards for the notice creditors must provide consumers prior to a home foreclosure. The goal would be to establish procedures that avoid unwarranted foreclosures by maximizing consumers' opportunities to cure a delinquency or arrange other financing. These procedures are especially important where a consumer who is overburdened by an abusive loan can qualify for financing on less onerous terms. See 1998 Joint Report, Chapter 6, at page 68.

Disclosures about Payment History -- The July notice solicited comment on whether creditors that choose not to report borrowers' positive payment history should be required to disclose that fact. Consumer representatives that commented on the issue suggested that the Board should require lenders to report a borrower's payment history to a nationally recognized credit bureau, or, at a minimum, require lenders to disclose whether they do or do not report borrowers' payment histories to credit bureaus. Industry representatives commenting on the issue noted that they currently report payment histories; these commenters generally supported a rule requiring reports of positive payment histories, although some noted that legislative action is necessary to effect such a requirement.

The Fair Credit Reporting Act (FCRA) sets standards for the collection, communication and use of information bearing on, among other things, consumers' creditworthiness, credit standing, and credit capacity. 15 U.S.C. 1681 et seq. The Act does not, however, require creditors to report any information. The FCRA also contains detailed requirements for the information that consumers are entitled to receive regarding creditors use of consumer reports. Because the Congress has regulated this area in detailed fashion under the FCRA, the Board believes that adding any rules governing the reporting of credit information is a policy matter better left to the Congress.

Prepayment Penalties -- For HOEPA loans, creditors' use of prepayment penalties is restricted during the first five years of a loan, and is prohibited after that. The July notice solicited comment on creditors' use of prepayment penalties, and whether it would be feasible to limit the use of prepayment penalties to transactions where consumers receive, in return, a benefit in the form of lower up-front costs or lower interest rates. In some cases, creditors impose prepayment penalties to ensure a minimum return on the transaction if loans are prepaid earlier than expected. In other cases, however, the penalty might be used only to deter the customer from refinancing the loan on more favorable terms. Because of the inherent difficulty in establishing a rule that addresses abusive practices without limiting consumer options in legitimate transactions, the Board is not proposing additional rules on prepayment penalties at this time.

Mandatory Arbitration -- Consumer representatives asked the Board to prohibit mandatory arbitration clauses for all HOEPA loans. These commenters maintain that mandatory arbitration clauses often contain provisions that limit the consumer's remedies, particularly with respect to punitive damages and class actions, or that require the consumer to bear the filing fees and other costs of arbitration. In light of the Federal Arbitration Act (FAA), there is a substantial federal question raised by these recommendations. In a recent decision, the Supreme Court reaffirmed that under the FAA, federal statutory claims may be appropriately resolved through arbitration. See Green Tree Financial Corp. v. Randolph, No. 99-1235, 2000 U.S. LEXIS 8279 (Dec. 11, 2000).

IV. Form of Comment Letters

Comment letters should refer to Docket No. R-1090, and, when possible, should use a standard typeface with a font size of 10 or 12. This will enable the Board to convert the text to machine-readable form through electronic scanning, and will facilitate automated retrieval of comments for review. Also, if accompanied by an original document in paper form, comments may be submitted on 3 1/2 inch computer diskettes in any IBM-compatible DOS- or Windows-based format.

V. Initial Regulatory Flexibility Analysis

In accordance with section 3(a) of the Regulatory Flexibility Act, the Board has reviewed the proposed amendments to Regulation Z. The proposed amendments would: (1) extend the protections of HOEPA to more loans; (2) prohibit certain acts or practices, to address some "loan flipping" within the first twelve months of a HOEPA loan, prohibiting the creditor or assignee that is holding the loan (or their affiliates) from refinancing it unless the holder demonstrates that it is in the borrower's interest; (3) strengthen HOEPA's prohibition on loans based on homeowners' equity without regard to repayment ability; and (4) improve disclosures received by consumers before closing. A regulatory flexibility analysis has been prepared by the Division of Research and Statistics. A final analysis will be conducted after consideration of comments received during the public comment period.

VI. Paperwork Reduction Act

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

The collection of information that is revised by this rulemaking is found in 12 CFR part 226 and in Appendices F, G, H, J, K, and L. This information is mandatory (15 U.S.C. 1601 et seq.) to evidence compliance with the requirements of Regulation Z and the Truth in Lending Act (TILA). The respondents/recordkeepers are for-profit financial institutions, including small businesses. Institutions are required to retain records for twenty-four months. This regulation applies to all types of creditors, not just state member banks. However, under Paperwork Reduction Act regulations, the Federal Reserve accounts for the burden of the paperwork associated with the regulation only for state member banks, their subsidiaries, and subsidiaries of bank holding companies (not otherwise regulated). Other agencies account for the paperwork burden on their respective constituencies under this regulation. The proposed rule would broaden the scope of two “high-cost” triggers (the APR trigger and the fee-based trigger) for mortgage loans; and would require creditors to revise a disclosure currently implemented in § 226.32 of Regulation Z. There should be a minimal burden increase associated with this revision due to the fact that most institutions use an automated version of the model forms provided in Appendix H and the calculation revisions need only be incorporated into an automated system one time. The disclosure revision would cover refinancings subject to HOEPA and would state the total loan amount of the borrower’s obligation (§ 226.32(c)(5)). Model clauses will be provided for this new disclosure to help minimize burden on the creditors.

With respect to state member banks, it is estimated that there are 988 respondent/ recordkeepers and an average frequency of 136,294 responses per respondent each year. Therefore, the current amount of annual burden is estimated to be 1,863,754 hours. The Federal Reserve will estimate the burden hours for: creating and distributing the three proposed disclosure requirements, programming systems with the proposed disclosures, revising the current disclosure affected by the APR trigger and the fee-based trigger changes, and updating systems with the new trigger figures. The staff will also reestimate the burden hours for all the current disclosure requirements. The Federal Reserve estimates that the annual burden hours imposed on creditors will increase by approximately 25 percent. The Federal Reserve believes that reverse and high-cost mortgages trigger special disclosures but are not typically offered by state member banks; thus the requirements have only a negligible effect on the paperwork burden for state member banks. The Federal Reserve solicits specific comments on: (1) whether state member banks offer reverse and high-cost mortgages, (2) the length of time creditors will devote to these proposed changes, and (3) the length of time creditors spend complying with current Regulation Z requirements.

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

522 (b)(4), (6) and (8)). The disclosures and information about error allegations are confidential between creditors and the customer.

The Federal Reserve requests comments from creditors, especially state member banks, that will help to estimate the number and burden of the various disclosures that would be made in the first year this proposed regulation would be effective. Comments are invited on: (a) the cost of compliance; (b) ways to enhance the quality, utility, and clarity of the information to be disclosed; and (c) ways to minimize the burden of disclosure on respondents, including through the use of automated disclosure techniques or other forms of information technology. Comments on the collection of information should be sent to the Office of Management and Budget, Paperwork Reduction Project (7100-0199), Washington, DC 20503, with copies of such comments sent to Mary M. West, Federal Reserve Board Clearance Officer, Division of Research and Statistics, Mail Stop 97, Board of Governors of the Federal Reserve System, Washington, DC 20551.

List of Subjects in 12 CFR Part 226

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

Text of Proposed Revisions

Certain conventions have been used to highlight the proposed revisions to the text of the staff commentary. New language is shown inside bold-faced arrows, while language that would be deleted is set off with bold-faced brackets. Brackets in proposed Model Form H-16 are not bold-faced; brackets are employed in the Board’s model clauses and samples to illustrate how creditors may adapt the required disclosures to the particular transaction.

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

PART 226 — TRUTH IN LENDING (REGULATION Z)

1. The authority citation for part 226 would continue to read as follows:
Authority: 12 U.S.C. 3806; 15 U.S.C. 1604 and 1637(c)(5).

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

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

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(d) Organization.

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(5) Subpart E **<**contains special rules for mortgage transactions. Section 226.32 requires certain disclosures and provides limitations for loans that have rates and fees above a specified amount. Section 226.33 requires disclosures, including the total annual loan cost rate, for reverse mortgage transactions. Section 226.34 prohibits specific acts and practices in connection with mortgage transactions.**=[**relates to mortgage transactions covered by § 226.32 and reverse mortgage transactions. It contains rules on disclosures, fees, and total annual loan cost rates.**]**

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3. Section 226.23 would be amended by revising footnote 48.

Subpart C—Closed-End Credit

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§ 226.23 Right of rescission.

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[48]The term “material disclosures” means the required disclosures of the annual percentage rate, the finance charge, the amount financed, the total of payments, the payment schedule, **[**and**]** the disclosures and limitations referred to in § 226.32(c) and (d)**<**, and provisions in a mortgage that are prohibited under § 226.34.**=**

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4. Section 226.32 would be amended by:

a. Revising paragraph (a)(1)(i);

b. Adding paragraph (b)(1)(iv);

c. Revising paragraph (c)(3) and adding paragraph (c)(5);

d. Adding paragraph (d)(8); and

e. Removing paragraph (e).

Subpart E—Special Rules for Certain Home Mortgage Transactions

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§ 226.32 Requirements for certain closed-end home mortgages.

(a) Coverage.

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

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

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

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

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<(iv) premiums or other charges for credit life, accident, health, or loss-of-income insurance, debt-cancellation coverage (whether or not the debt-cancellation coverage is insurance under applicable law), or similar products.=

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

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(3) Regular payment<; balloon payment=. The amount of the regular monthly (or other periodic) payment <and the amount of a balloon payment=.

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<(5) Amount borrowed. For a mortgage refinancing, the total amount the consumer will borrow, as reflected by the face amount of the note.=

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(d) Limitations. A mortgage transaction subject to this section may not provide for the following terms:

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

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

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

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

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

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

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

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

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

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

(2) Notice to assignee. Sell or otherwise assign a mortgage subject to § 226.32 without furnishing the following statement to the purchaser or assignee: "Notice: This is a mortgage subject to special rules under the federal Truth in Lending Act. Purchasers or assignees of this mortgage could be liable for all claims and defenses with respect to the mortgage that the borrower could assert against the creditor."

(3) Refinancings within Twelve-month period. Refinance a loan subject to § 226.32 within the first twelve months unless the refinancing is in the borrower's interest, if the creditor (or its affiliate) holds the existing loan. Creditors are prohibited from engaging in acts or practices to evade this provision, including arranging for the refinancing of its own loans with unaffiliated creditors, or modifying a loan agreement (whether or not the existing loan is satisfied and replaced by the new loan) and charging a fee.

(4) Repayment ability. (i) Engage in a pattern or practice of extending credit subject to § 226.32 to a consumer based on the consumer's collateral without regard to the consumer's repayment ability, including the consumer's current and expected income, current obligations, and employment.

(ii) If a creditor engages in a pattern or practice of making loans subject to § 226.32 without documenting and verifying consumers' repayment ability, such as the consumer's current or expected income, current obligations, and employment status, there is a presumption that the creditor has violated paragraph (a)(4)(i) of this section.

(b) Prohibited acts or practices for dwelling-secured loans. A creditor may not engage in the following acts or practices in connection with credit secured by the consumer's dwelling:

(1) Limitations on refinancing certain low-rate loans. Replacing or consolidating a zero interest rate or other low-cost loan with a higher-rate loan within the first five years, unless the refinancing is in the borrower's interest. For purposes of this paragraph, a "low-cost" loan is:

(i) a fixed-rate loan that carries an interest rate two percentage points or more below the yield on Treasury securities with a comparable maturity; or

(ii) a variable-rate loan where the current interest rate is at least two percentage points below the index or formula used to make rate adjustments.

(2) Open-end credit. Structuring a home-secured loan as an open-end plan to evade the requirements of § 226.32, if the credit does not meet the definition in § 226.2(a)(20).**=**

6. Appendix H to Part 226 would be amended by revising Appendix H-16.

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

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H-16—Mortgage Sample

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

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

You could lose your home, and any money you have put into it,
If you do not meet your obligations under the loan.

<[You are borrowing $______________.]**=**

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

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

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

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

a. Under Section 226.31—General Rules, under Paragraph 31(c)(1)(i), paragraph 2. would be added;

b. Under Section 226.32—Requirements for Certain Closed-End Home Mortgages, under Paragraph 32(a)(1)(ii), paragraph 1. would be revised;

c. Under Section 226.32— Requirements for Certain Closed-End Home Mortgages, a new heading 32(b)(1)(iv) would be added and a new paragraph 1. would be added;

d. Under Section 226.32—Requirements for Certain Closed-End Home Mortgages, under 32(c)(3), paragraph 1. would be revised and paragraph 2. would be deleted;

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

f. Under Section 226.32—Requirements for Certain Closed-End Home Mortgages, 32(e) would be removed;

g. A new Section 226.34—Prohibited Acts or Practices in Connection with Credit Secured by a Consumer's Dwelling would be added; and

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

SUBPART E—SPECIAL RULES FOR CERTAIN HOME MORTGAGE TRANSACTIONS
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Section 226.31 – General Rules

Section 31(c) Timing of disclosure.

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

▸2. Sale of optional products at consummation. If the consumer finances the purchase of optional products such as credit insurance and as a result the monthly payment differs from what was previously disclosed under § 226.32, redisclosure is required and a new three-day waiting period applies. (See comment 32(c)(3)-1 on when optional items may be included in the regular payment disclosure.)◂
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Section 226.32—Requirements for Certain Closed-End Home Mortgages

32(a) Coverage.

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

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

<iv. If the consumer financed a $300 fee for a creditor-conducted appraisal and a $500 single premium for optional credit life insurance, and pays $400 in points at closing, the amount financed under § 226.18(b) is $10,400 ($10,000, plus the $300 appraisal fee that is paid to and financed by the creditor, plus the $500 insurance premium that is financed by the creditor, less $400 in prepaid finance charges). The $300 appraisal fee paid to the creditor is added to other points and fees under § 226.32(b)(1)(iii), and the $500 insurance premium is added under § 226.32(b)(1)(iv). The $300 and $500 costs are deducted from the amount financed ($10,400) to derive a total loan amount of $9,600.**=**
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32(b) Definitions
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<Paragraph 32(b)(1)(iv).

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

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32(c) Disclosures.

Paragraph 32(c)(3) Regular payment.

1. General. The regular payment is the amount due from the borrower at regular intervals, such as monthly, bimonthly, quarterly, or annually. There must be at least two payments, and the payments must be in an amount and at such intervals that they fully amortize the amount owed. In disclosing the regular payment, creditors may rely on the rules set forth in § 226.18(g); however, the amounts for voluntary items ►, such as credit life insurance, may be included in the regular payment disclosure only if the consumer has previously agreed to the items.◄ **[**not agreed to by the consumer such as credit life insurance may not be included in the regular payment.**]**

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32(d) Limitations

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<32(d)(8) Due-on-demand clauses.

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

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

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

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

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

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

(B) The consumer fails to maintain required insurance on the dwelling.

(C) The consumer fails to pay taxes on the property.

(D) The consumer permits the filing of a lien senior to that held by the creditor.

(E) The sole consumer obligated on the plan dies.

(F) The property is taken through eminent domain.

(G) A prior lienholder forecloses.

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

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

Paragraph 34(a) Prohibited Acts or Practices for Loans Subject to § 226.32.

Paragraph 34(a)(1) Home-Improvement Contracts.

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

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

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

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

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

3. Assignee liability. Pursuant to section 131(d) of the act, the act's general holder-in-due course protections do not apply to purchasers and assignees of loans covered by § 226.32.

Paragraph 34(a)(3) Refinancings within twelve-month period.

1. Benefit to the borrower. The determination of whether or not a benefit exists would be based on the totality of the circumstances. For example, consideration should be given to the amount of any new funds advanced in comparison to the total loan charges on the refinancing (which may be based predominately on the pre-existing loan balance).

Paragraph 34(a)(4) Repayment ability.
Paragraph 34(a)(4)(i).

1. Determining repayment ability. The information provided to creditors in connection with § 226.32(d)(7) may be used to show that creditors considered the consumer's income and obligations before extending the credit. Any expected income can be considered by the creditor, except equity income that the consumer would obtain through the foreclosure of the consumer's principal dwelling. For example, a creditor may use information about income other than regular salary or wages such as gifts, expected retirement payments, or income from housecleaning or childcare.

2. Pattern or practice of extending credit—repayment ability. Whether a creditor has engaged in a pattern or practice of violations of this section depends on the totality of the circumstances in each particular case. General guidance, however, on pattern or practice for purposes of this section can be found in case law interpreting pattern or practice provisions in the Truth in Lending Act, the Equal Credit Opportunity Act (ECOA), the Fair Housing Act (FHA), and Title VII of the Civil Rights Act of 1964 (equal employment opportunity).

3. Discounted introductory rates. In transactions where the creditor sets the initial interest rate and the rate is later adjusted (whether fixed or later determined by an index or formula), in determining repayment ability the creditor must consider increases to the consumer's payments based on the maximum possible increases in rates in the shortest possible time frame.

Paragraph 34(a)(4)(ii).

1. Documenting and verifying income. Creditors may document and verify a consumer's repayment ability in various ways. For example, a creditor may document and verify a consumer's income and current obligations through a consumer's signed financial statement, a credit report, and payment records for employment income. For the self-employed, in lieu of employment payment records, a creditor may rely on tax returns or any other source that provides the creditor with a reasonable basis for believing that the income exists and will support the loan.
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Paragraph 34(b)(1) Limitation on refinancing certain low-rate loans.

1. Borrower's statement. A creditor may rely on a statement by the borrower regarding the current rate of interst on their existing loan.
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APPENDIX H TO PART 226--CLOSED-END MODEL FORMS AND CLAUSES

<20. Sample H-16. This sample illustrates the disclosures required under § 226.32(c). The sample includes disclosures required under § 226.32(c)(3) when the legal obligation includes a balloon payment. The sample also illustrates the disclosures required for refinancings under § 226.32(c)(5) and § 226.32(c)(6). Although these disclosures are required for refinancings that are subject to § 226.32, creditors may, at their option, include these disclosures for all loans subject to that section.=

By order of the Board of Governors of the Federal Reserve System, December 15, 2000.

Signed (Jennifer J. Johnson
Jennifer J. Johnson
Secretary of the Board