FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Regulation Z; Docket No. R–1305]

Truth in Lending

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule; request for public comment.

SUMMARY: The Board proposes to amend Regulation Z, which implements the Truth in Lending Act and Home Ownership and Equity Protection Act. The goals of the amendments are to protect consumers in the mortgage market from unfair, abusive, or deceptive lending and servicing practices while preserving responsible lending and sustainable homeownership; ensure that advertisements for mortgage loans provide accurate and balanced information and do not contain misleading or deceptive representations; and provide consumers transaction-specific disclosures early enough to use while shopping for a mortgage. The proposed revisions would apply four protections to a newly-defined category of higher-priced mortgage loans secured by a consumer's principal dwelling, including a prohibition on a pattern or practice of lending based on the collateral without regard to consumers' ability to repay their obligations from income, or from other sources besides the collateral. The proposed revisions would apply three new protections to mortgage loans secured by a consumer's principal dwelling regardless of loan price, including a prohibition on a creditor paying a mortgage broker more than the consumer had agreed the broker would receive. The Board also proposes to require that advertisements provide accurate and balanced information, in a clear and conspicuous manner, about rates, monthly payments, and other loan features; and to ban several deceptive or misleading advertising practices, including representations that a rate or payment is ''fixed'' when it can change. Finally, the proposal would require creditors to provide consumers with transaction-specific mortgage loan disclosures before they pay any fee except a reasonable fee for reviewing credit history.

DATES: Comments must be received on or before April 8, 2008.

ADDRESSES: You may submit comments, identified by Docket No. R–1305, by any of the following methods:

- *Agency Web site: http://www.federalreserve.gov.* Follow the instructions for submitting comments at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.*
- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.
- *E-mail: regs.comments@federalreserve.gov.* Include the docket number in the subject line of the message.
- *Fax:* (202) 452–3819 or (202) 452–3102.
- *Mail:* Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments will be made available on the Board's Web site at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm* as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP–500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Kathleen C. Ryan, Dan S. Sokolov, or David Stein, Counsels; Jamie Z. Goodson, Brent Lattin, Jelena McWilliams, or Paul Mondor, Attorneys; Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, DC 20551, at (202) 452–2412 or (202) 452–3667. For users of Telecommunications Device for the Deaf (TDD) only, contact (202) 263–4869.

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I. Summary of Proposal

The Board is proposing to establish new regulatory protections for consumers in the residential mortgage market through amendments to Regulation Z, which implements the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA). The goals of the amendments are to protect consumers in the mortgage market from unfair, abusive, or deceptive lending and servicing practices while preserving responsible lending and sustainable homeownership; ensure that advertisements for mortgage loans provide accurate and balanced information and do not contain misleading or deceptive representations; and provide consumers transaction-specific disclosures early enough to use while shopping.

A. Proposals To Prevent Unfairness, Deception, and Abuse

The Board is proposing seven new restrictions or requirements for mortgage lending and servicing intended to protect consumers against unfairness, deception, and abuse while preserving responsible lending and sustainable homeownership. The restrictions would be adopted under TILA Section 129(l)(2), which authorizes the Board to prohibit unfair or deceptive practices in connection with mortgage loans, as well as to prohibit abusive practices or practices not in the interest of the borrower in connection with refinancings. 15 U.S.C. 1639(l)(2). Some of the restrictions would apply only to higher-priced mortgage loans, while others would apply to all mortgage loans secured by a consumer's principal dwelling.

Protections Covering Higher-Priced Mortgage Loans

The Board is proposing four protections for consumers receiving higher-priced mortgage loans. These loans would be defined as consumer-purpose, closed-end loans secured by a consumer's principal dwelling and having an annual percentage rate (APR) that exceeds the comparable Treasury security by three or more percentage points for first-lien loans, or five or more percentage points for subordinate-lien loans. For higher-priced mortgage loans, the Board proposes to:

○ Prohibit creditors from engaging in a pattern or practice of extending credit without regard to borrowers' ability to repay from sources other than the collateral itself;

○ Require creditors to verify income and assets they rely upon in making loans;

○ Prohibit prepayment penalties unless certain conditions are met; and

○ Require creditors to establish escrow accounts for taxes and insurance, but permit creditors to allow borrowers to opt out of escrows 12 months after loan consummation.

In addition, the proposal would prohibit creditors from structuring closed-end mortgage loans as open-end lines of credit for the purpose of evading these rules, which do not apply to lines of credit.

Protections Covering Closed-End Loans Secured by Consumer's Principal Dwelling

In addition, in connection with all consumer-purpose, closed-end loans secured by a consumer's principal dwelling, the Board is proposing to:

○ Prohibit creditors from paying a mortgage broker more than the consumer had agreed in advance that the broker would receive;

○ Prohibit any creditor or mortgage broker from coercing, influencing, or otherwise encouraging an appraiser to provide a misstated appraisal in connection with a mortgage loan; and

○ Prohibit mortgage servicers from ''pyramiding'' late fees, failing to credit payments as of the date of receipt, failing to provide loan payoff statements upon request within a reasonable time, or failing to deliver a fee schedule to a consumer upon request.

B. Proposals To Improve Mortgage Advertising

Another goal of this proposal is to ensure that mortgage loan advertisements provide accurate and balanced information and do not contain misleading or deceptive representations. Thus the Board is proposing to require that advertisements for both open-end and closed-end mortgage loans provide accurate and balanced information, in a clear and conspicuous manner, about rates, monthly payments, and other loan features. This proposal is made under the Board's general authority to adopt regulations to ensure consumers are informed about and can shop for credit. TILA Section 105(a), 15 U.S.C. 1604(a).

The Board is also proposing, under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), to prohibit the following seven deceptive or misleading practices in advertisements for closed-end mortgage loans:

○ Advertising ''fixed'' rates or payments for loans whose rates or payments can vary without adequately disclosing that the interest rate or payment amounts are ''fixed'' only for a limited period of time, rather than for the full term of the loan;

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

○ Advertisements that characterize the products offered as ''government loan programs,'' ''government-supported loans,'' or otherwise endorsed or sponsored by a federal or state government entity even though the advertised products are not government-supported or -sponsored loans;

○ Advertisements, such as solicitation letters, that display the name of the consumer's current mortgage lender, unless the advertisement also prominently discloses that the advertisement is from a mortgage lender not affiliated with the consumer's current lender;

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

○ Advertisements that create a false impression that the mortgage broker or lender has a fiduciary relationship with the consumer; and

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

C. Proposal To Give Consumers Disclosures Early

A third goal of this proposal is to provide consumers transaction-specific disclosures early enough to use while shopping for a mortgage loan. The Board proposes to require creditors to provide transaction-specific mortgage loan disclosures such as the APR and payment schedule for all home-secured, closed-end loans no later than three days after application, and before the consumer pays any fee except a reasonable fee for the originator's review of the consumer's credit history.

The Board recognizes that these disclosures need to be updated to reflect the increased complexity of mortgage products. In early 2008, the Board will begin testing current TILA mortgage disclosures and potential revisions to these disclosures through one-on-one interviews with consumers. The Board expects that this testing will identify potential improvements for the Board to propose for public comment in a separate rulemaking.

II. Consumer Protection Concerns in the Subprime Market

A. Recent Problems in the Mortgage Market

Subprime mortgage loans are made to borrowers who are perceived to have high credit risk. These loans' share of total consumer originations, according to one estimate, reached about nine percent in 2001 and doubled to 20 percent by 2005, where it stayed in 2006.[1] The resulting increase in the supply of mortgage credit likely contributed to the rise in the homeownership rate from 64 percent in 1994 to a high of 69 percent in 2006—though about 68 percent now—and expanded consumers' access to the equity in their homes. Recently, however, some of this benefit has

[1] Inside Mortgage Finance Publications, Inc., *The 2007 Mortgage Market Statistical Annual* vol. I (*IMF 2007 Mortgage Market*), at 4.

eroded. In the last two years, delinquencies and foreclosure starts among subprime mortgages have increased dramatically and reached exceptionally high levels as house price growth has slowed or prices have declined in some areas. The proportion of all subprime mortgages past-due ninety days or more (''serious delinquency'') was about 13 percent in October 2007, more than double the mid-2005 level.[2] Adjustable-rate subprime mortgages have performed the worst, reaching a serious delinquency rate of nearly 19 percent in October 2007, triple the mid-2005 level. These mortgages have seen unusually high levels of early payment default, or default after only one or two payments or even no payment at all.

The serious delinquency rate has also risen for loans in alt-A (near prime) securitized pools. According to one source, originations of these loans were 13 percent of consumer mortgage originations in 2006.[3] Alt-A loans are made to borrowers who typically have higher credit scores than subprime borrowers, but the loans pose more risk than prime loans because they involve small down payments or reduced income documentation, or the terms of the loan are nontraditional and may increase risk. The rate of serious delinquency for these loans has risen to over 3 percent (as of September 2007) from 1 percent only a year ago. In contrast, 1 percent of loans in the prime-mortgage sector were seriously delinquent as of October.

The consequences of default are severe for homeowners, who face the possibility of foreclosure, the loss of accumulated home equity, higher rates for other credit transactions, and reduced access to credit. When foreclosures are clustered, they can injure entire communities by reducing property values in surrounding areas. Higher delinquencies are in fact showing through to foreclosures. Lenders initiated 430,000 foreclosures in the third quarter of 2007, about half of them on subrpime mortgages. This was significantly higher than the quarterly average of 325,000 in the first half of the year, and nearly twice the quarterly average of 225,000 for the past six years.[4]

B. The Loosening of Underwriting Standards

Rising delinquencies have been caused largely by a combination of a decline in house price appreciation—and in some areas slower economic growth—and a loosening of underwriting standards. Underwriting standards loosened in large parts of the mortgage market in recent years as lenders—particularly nondepository institutions, many of which have since ceased to exist—competed more aggressively for market share. This loosening was particularly pronounced in the subprime sector, where the frequent combination of several riskier loan attributes—high loan-to-value ratio, payment shock on adjustable-rate mortgages, no verification of borrower income, and no escrow for taxes and insurance—increased the risk of serious delinquency and foreclosure for subprime loans originated in 2005 through early 2007.

Payment shock from rate adjustments within two or three years of origination could make these loans unaffordable to many of the consumers who hold them. Approximately three-fourths of originations in securitized subprime ''pools'' from 2004 to 2006 were adjustable-rate mortgages (ARMs) with two-or three-year ''teaser'' rates followed by substantial increases in the rate and payment (so-called ''2–28'' and ''3–27'' mortgages).[5] The burden of these payment increases on the borrower would likely be heavier than expected if the borrower's stated income was inflated, as appears to have happened in some cases, and the inflated figure was used to determine repayment ability. In addition, affordability problems with subprime loans can be compounded by unexpected property tax and homeowners insurance obligations. In the prime market, lenders typically establish escrows for these obligations, but in the subprime market escrows have been the exception rather than the rule.

Delinquencies and foreclosure initiations in subprime ARMs are expected to rise further as more of these mortgages see their rates and payments reset at significantly higher levels. On average in 2008, 374,000 subprime mortgages per quarter are scheduled to undergo their first interest rate and payment reset. Relative to past years, avoiding the payment shock of an interest rate reset by refinancing the mortgage will be much more difficult. Not only have home prices flattened out or declined, thereby reducing homeowners' equity, but borrowers often had little equity to start with because of very high initial cumulative loan-to-value ratios. Moreover, prepayment penalty clauses, which are found in a substantial majority of subprime loans, place an added demand on the limited equity or other resources available to many borrowers and make it harder still for them to refinance. Borrowers who cannot refinance will have to make sacrifices to stay in their homes or could lose their homes altogether.[6]

Relaxed underwriting was not limited to the subprime market. According to one estimate, interest-only mortgages (most of them with adjustable rates) and ''option ARMs''—which permit borrowers to defer both principal and interest for a time in exchange for higher payments later—rose from 7 percent of total consumer mortgage originations in 2004 to 26 percent in 2006.[7] By one estimate these mortgages reached 78 percent of alt-A originations in 2006.[8] These types of mortgages hold the potential for payment shock and increasingly contained additional layers of risk such as loan amounts near the full appraised value of the home, and partial or no documentation of income. For example, the share of interest-only mortgages with low or no documentation in alt-A securitized pools increased from around 60 percent in 2003 to nearly 80 percent in 2006.[9] Most of these mortgages have not yet reset so their full implications are not yet apparent. The risks to consumers and to creditors were serious enough, however, to cause the federal banking agencies to issue supervisory guidance, which many state agencies later adopted.[10]

A decline in underwriting standards does not just increase the risk that consumers will be provided loans they cannot repay. It also increases the risk that originators will engage in an abusive strategy of ''flipping'' borrowers in a succession of refinancings, ostensibly to lower borrowers' burdensome payments, that strip borrowers' equity and provide them no

[2] Delinquency rates calculated from data from First American LoanPerformance on mortgages in subprime securitized pools. Figures include loans on non-owner-occupied properties.

[3] *IMF 2007 Mortgage Market,* at 4.

[4] Estimates are based on data from Mortgage Bankers' Association's *National Delinquency Survey* (2007).

[5] Figure calculated from First American Loan Performance data.

[6] These effects may be mitigated for some borrowers by a recently-announced agreement among major loan servicers and investors to ''freeze'' many subprime ARMs at their initial interest rates for five years.

[7] *IMF 2007 Mortgage Market,* at 6.

[8] David Liu & Shumin Li, *Alt-A Credit—The Other Shoe Drops?,* The MarketPulse (First American LoanPerformance, Inc., San Francisco, Cal.), Dec. 2006.

[9] Figures calculated from First American LoanPerformance data.

[10] Interagency Guidance on Nontraditional Mortgage Product Risks, 71 FR 58609, Oct. 4, 2006.

benefit. Moreover, an atmosphere of relaxed standards may increase the incidence of abusive lending practices by attracting less scrupulous originators into the market, while at the same time bringing more vulnerable borrowers into the market. These abuses can lead consumers to pay more for their loans than their risk profiles warrant.

The market has responded to the current problems with increasing attention to loan quality. Structural factors, or market imperfections, however, make it necessary to consider regulations to help prevent a recurrence of these problems. New regulation can also provide the market clear ''rules of the road'' at a time of uncertainty, so that responsible higher-priced lending, which serves a critical need, may continue.

C. Market Imperfections That Can Facilitate Abusive and Unaffordable Loans

The recent sharp increase in serious delinquencies has highlighted the roles that structural elements of the subprime mortgage market may play in increasing the likelihood of injury to consumers who find themselves in that market. Limitations on price and product transparency in the subprime market—often compounded by misleading or inaccurate advertising—may make it harder for consumers to protect themselves from abusive or unaffordable loans, even with the best disclosures. The injuries consumers in the subprime market may suffer as a result are magnified when originators' incentives to carefully assess consumers' repayment ability grow weaker, as can happen when originators sell off their loans to be securitized. The fragmentation of the originator market can further exacerbate the problem by making it more difficult for investors to monitor originators and for lenders to monitor brokers. The multiplicity of originators and their regulators can also inhibit the ability of regulators to protect consumers from abusive and unaffordable loans.

Limited Transparency and Limits of Disclosure

Limited transparency in the subprime market increases the risk that borrowers in that market will receive unaffordable or abusive loans. The transparency of the subprime market to consumers is limited in several respects. First, price information for the subprime market is not widely and readily available to consumers. A consumer searching in the prime market can buy a newspaper or access the Internet and easily find current interest rates from a wide variety of lenders without paying a fee. In contrast, subprime rates, which can vary significantly based on the individual borrower's risk profile, are not broadly advertised. Advertising in the subprime market focuses on easy approval and low payments. Moreover, a borrower shopping in the subprime market generally cannot obtain a useful rate quote from a particular lender without submitting an application and paying a fee. The quote may not even be reliable, as loan originators sometimes use ''bait and switch'' strategies.

Second, products in the subprime market tend to be complex, both relative to the prime market and in absolute terms, as well as less standardized than in the prime market.[11] As discussed earlier, subprime originations have much more often had adjustable rates than more easily understood fixed rates. Adjustable-rate mortgages require consumers to make judgments about the future direction of interest rates and translate expected rate changes into changes in their payment amounts. Subprime loans are also far more likely to have prepayment penalties. The price of the penalty is not reflected in the annual percentage rate (APR); to calculate that price, the consumer must both calculate the size of the penalty according to a formula such as six months of interest, and assess the likelihood the consumer will move or refinance during the penalty period. In these and other ways subprime products tend to be complex for consumers.

Third, the roles and incentives of originators are not transparent. One source estimates that 60 percent or more of mortgages originated in the last several years were originated through a mortgage broker, often an independent entity, who takes loan applications from consumers and shops them to depository institutions or other lenders.[12] Anecdotal evidence indicates that consumers in both the prime and subprime markets often believe, in error, that a mortgage broker is obligated to find the consumer the best and most suitable loan terms available. For example, in a 2003 survey of older borrowers who had obtained prime or subprime refinancings, seventy percent of respondents with broker-originated refinance loans reported that they had relied ''a lot'' on their brokers to find the best mortgage for them.[13] Consumers who rely on brokers often are unaware, however, that a broker's interests may diverge from, and conflict with, their own interests. In particular, consumers are often unaware that a creditor pays a broker more to originate a loan with a rate higher than the rate the consumer qualifies for based on the creditor's underwriting criteria.

Limited shopping. In this environment of limited transparency, consumers—particularly those in the subprime market—who have been told by an originator that they will receive a loan from that originator may reasonably decide not to shop further among originators or among loan options. The costs of further shopping may be significant, including completing another application form and paying yet another application fee. Delaying receipt of funds is another cost of continuing to shop, a potentially significant one for the many borrowers in the subprime market who are seeking to refinance their obligations to lower their debt payments at least temporarily, to extract equity in the form of cash, or both.[14] Nearly 90 percent of subprime ARMs used for refinancing in recent years were ''cash out.''[15]

While the cost of continuing to shop is likely obvious, the benefit may not be

[11] U.S. Dep't of Hous. & Urban Dev. & U.S. Dep't of Treasury, *Recommendations to Curb Predatory Home Mortgage Lending* 17 (2000) (''While predatory lending can occur in the prime market, such practices are for the most part effectively deterred by competition among lenders, greater homogeneity in loan terms and the prime borrowers' greater familiarity with complex financial transactions.''); Howard Lax, Michael Manti, Paul Raca & Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency (Subprime Lending Investigation),* 15 Housing Policy Debate 3, 570 (2004) (stating that the subprime market lacks the ''overall standardization of products, underwriting, and delivery systems'' that is found in the prime market).

[12] Data reported by Wholesale Access Mortgage Research and Consulting, Inc., available at *http://www.wholesaleaccess.com/8-17-07-prs.shtml; http://www.wholesaleaccess.com/7_28_mbkr.shtml.*

[13] Kellie K. Kim-Sung & Sharon Hermanson, *Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans,* Data Digest No. 83 (AARP Public Policy Inst., Washington, DC), Jan. 2003, at 3, available at *http://www.aarp.org/research/credit-debt/mortgages/experiences_of_older_refinance_mortgage_loan_borro.html.*

[14] *See* Anthony Pennington-Cross & Souphala Chomsisengphet, *Subprime Refinancing: Equity Extraction and Mortgage Termination*, 35 Real Estate Economics 2, 233 (2007) (reporting that 49% of subprime refinance loans involve equity extraction, compared with 26% of prime refinance loans); Marsha J. Courchane, Brian J. Surette, and Peter M. Zorn, *Subprime Borrowers: Mortgage Transitions and Outcomes (Subprime Outcomes)*, 29 J. of Real Estate Economics 4, 368–371 (2004) (discussing survey evidence that borrowers with subprime loans are more likely to have experienced major adverse life events (marital disruption; major medical problem; major spell of unemployment; major decrease of income) and often use refinancing for debt consolidation or home equity extraction); *Subprime Lending Investigation*, at 551–552 (citing survey evidence that borrowers with subprime loans have increased incidence of major medical expenses, major unemployment spells, and major drops in income).

[15] Figure calculated from First American LoanPerformance data.

clear or may appear quite small. Without easy access to subprime product prices, a consumer who has been offered a loan by one originator may have only a limited idea whether further shopping is likely to produce a better deal. Moreover, consumers in the subprime market have reported in studies that they were turned down by several lenders before being approved.[16] Once approved, these consumers may see little advantage to continuing to shop if they expect, based on their experience, that many of their applications to other originators would be turned down. Furthermore, if a consumer uses a broker and believes that the broker is shopping for the consumer, the consumer may believe the chance of finding a better deal than the broker is small. An unscrupulous originator may also seek to discourage a consumer from shopping by intentionally understating the cost of an offered loan. For all of these reasons, borrowers in the subprime market may not shop beyond the first approval and may be willing to accept unfavorable terms.[17]

Limited focus. Consumers considering obtaining a typically complex subprime mortgage loan may simplify their decision by focusing on a few attributes of the product or service that seem most important.[18] A consumer may focus on loan attributes that have the most obvious and immediate consequence such as loan amount, down payment, initial monthly payment, initial interest rate, and up-front fees (though up-front fees may be more obscure when added to the loan amount, and ''discount points'' in particular may be difficult for consumers to understand). These consumers, therefore, may not focus on terms that may seem less immediately important to them such as future increases in payment amounts or interest rates, prepayment penalties, and negative amortization. They are also not likely to focus on underwriting practices such as income verification, and on features such as escrows for future tax and insurance obligations.[19] Consumers who do not fully understand such terms and features, however, are less able to appreciate their risks, which can be significant. For example, the payment may increase sharply and a prepayment penalty may hinder the consumer from refinancing to avoid the payment increase. Thus, consumers may unwittingly accept loans that they will have difficulty repaying.

Limits of disclosure. Disclosures describing the multiplicity of features of a complex loan could help some consumers in the subprime market, but disclosures may not be sufficient to protect them against unfair loan terms or lending practices. Obtaining widespread consumer understanding of the many potentially significant features of a typical subprime product is a major challenge.[20] Moreover, even if all of a loan's features are disclosed clearly to consumers, they may continue to focus on a few features that appear most significant. Alternatively, disclosing all features may ''overload'' consumers and make it more difficult for them to discern which features are most important.

Furthermore, a consumer cannot make effective use of disclosures without having a certain minimum level of understanding of the market and products. Disclosures themselves, likely cannot provide this minimum understanding for transactions that are complex and that consumers engage in infrequently. Moreover, consumers may rely more on their originators to explain the disclosures when the transaction is complex; some originators may have incentives to misrepresent the disclosures so as to obscure the transaction's risks to the consumer; and such misrepresentations may be particularly effective if the originator is face-to-face with the consumer.[21] Therefore, while the Board anticipates proposing changes to Regulation Z to improve mortgage loan disclosures, it appears unlikely that better disclosures, alone, will address adequately the risk of abusive or unaffordable loans in the subprime market.

Misaligned Incentives and Obstacles to Monitoring

Not only are consumers in the subprime market often unable to protect themselves from abusive or unaffordable loans, originators may at certain times be more likely to extend unaffordable loans. The recent sharp rise in serious delinquencies on subprime mortgages has made clear that originators may not give adequate attention to repayment ability if they sell the mortgages they originate and bear little loss if the mortgages default. The growth of the secondary market gave lenders—and, thus, mortgage borrowers—greater access to capital markets, lowered transaction costs, and allowed risk to be shared more widely. This ''originate-to-distribute'' model, however, may also tend to contribute to the loosening of underwriting standards, particularly during periods of rapid house price appreciation, which may mask problems by keeping default and delinquency rates low until price appreciation slows or reverses.

This potential tendency has several related causes. First, when an originator sells a mortgage and its servicing rights, depending on the terms of the sale, most or all of the risks typically are passed on

[16] James M. Lacko & Janis K. Pappalardo, Fed. Trade Comm'n, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms (Improving Mortgage Disclosures)*, 24–26 (2007) (reporting evidence based on qualitative consumer interviews); Subprime Lending Investigation, at 550 (finding based on survey data that ''[p]robably the most significant hurdle overcome by subprime borrowers * * * is just getting approved for a loan for the first time. This impact might well make subprime borrowers more willing to accept less favorable terms as they become uncertain about the possibility of qualifying for a loan at all.'').

[17] *Subprime Outcomes*, at 371–372 (reporting survey evidence that relative to prime borrowers, subprime borrowers are less knowledgeable about the mortgage process, search less for the best rates, and feel they have less choice about mortgage terms and conditions); *Subprime Mortgage Investigation*, at 554 (''Our focus groups suggested that prime and subprime borrowers use quite different search criteria in looking for a loan. Subprime borrowers search primarily for loan approval and low monthly payments, while prime borrowers focus on getting the lowest available interest rate. These distinctions are quantitatively confirmed by our survey.'').

[18] Jinkook Lee & Jeanne M. Hogarth, *Consumer Information Search for Home Mortgages: Who, What, How Much, and What Else? (Consumer Information Search)*, Financial Services Review 291 (2000) (''In all, there are dozens of features and costs disclosed per loan, far in excess of the combination of terms, lenders, and information sources consumers report using when shopping.'').

[19] *Consumer Information Search*, at 285 (reporting survey evidence that most consumers compared interest rate or APR, loan type (fixed-rate or ARM), and mandatory up-front fees, but only a quarter considered the costs of optional products such as credit insurance and back-end costs such as late fees). There is evidence that borrowers are not aware of, or do not understand, terms of this nature even after they have obtained a loan. *See Improving Mortgage Disclosures*, at 27–30 (discussing anecdotal evidence based on consumer interviews that borrowers were not aware of, did not understand, or misunderstood an important cost or feature of their loans that had substantial impact on the overall cost, the future payments, or the ability to refinance with other lenders); Brian Bucks & Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?* 18–22 (Fed. Reserve Bd. of Governors Fin. and Econ. Discussion Series Working Paper No. 2006–3, 2006) (discussing statistical evidence that borrowers with ARMs underestimate annual as well as life-time caps on the interest rate; the rate of underestimation increases for lower-income and less-educated borrowers), available at *http://www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf*.

[20] *Improving Mortgage Disclosures*, at 74–76 (finding that borrowers in the subprime market may have more difficulty understanding their loan terms because their loans are more complex than loans in the prime market).

[21] U.S. Gen. Accounting Office, GAO 04–280, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending* 97–98 (2004) (stating that the inherent complexity of mortgage loans, some borrowers' lack of financial sophistication, education, or infirmities, and misleading statements and actions by lenders and brokers limit the effectiveness of even clear and transparent disclosures).

to the loan purchaser. Thus, originators who sell loans may have less of an incentive to undertake careful underwriting than if they kept the loans. Second, warranties by sellers to purchasers and other ''repurchase'' contractual provisions have little meaningful benefit if originators have limited assets. Third, fees for some loan originators have been tied to loan volume, making loan sales—sometimes accomplished through aggressive ''push marketing''—a higher priority than loan quality for some originators. Fourth, investors may not exercise adequate due diligence on mortgages in the pools in which they are invested, and may instead rely heavily on credit-ratings firms to determine the quality of the investment.

The fragmentation of the originator market can further exacerbate the problem. Data reported under HMDA show that independent mortgage companies—those not related to depository institutions or their subsidiaries or affiliates—made nearly one-half of higher-priced first-lien mortgages in 2005 and 2006 but only one-fourth of loans that were not higher-priced. Nor was lending by independent mortgage companies particularly concentrated: In each of 2005 and 2006 around 150 independent mortgage companies made 500 or more higher-priced first-lien mortgage loans on owner-occupied dwellings. In addition, one source suggests that 60 percent or more of mortgages originated in the last several years were originated through a mortgage broker.[22] This same source estimates the number of brokerage companies at over 50,000 in recent years.

Thus, a securitized pool of mortgages may have been sourced by tens of lenders and thousands of brokers. Investors have limited ability to directly monitor these originators' activities. Similarly, a lender may receive a handful of loans from each of hundreds or thousands of small brokers every year. A lender has limited ability or incentive to monitor every small brokerage's operations and performance.

Government oversight of such a fragmented originator market faces significant challenges. The various lending institutions and brokers operate in fifty different states and the District of Columbia with different regulatory and supervisory regimes, varying resources for supervision and enforcement, and different practices in sharing information among regulators. State regulatory regimes come under particular pressure when a booming market brings new lenders and brokers into the marketplace more rapidly than regulators can increase their oversight resources. These circumstances may inhibit the ability of regulators to protect consumers from abusive and unaffordable loans.

A Role for New HOEPA Rules

As explained above, consumers in the subprime market face serious constraints on their ability to protect themselves from abusive or unaffordable loans, even with the best disclosures; originators themselves may at times lack sufficient market incentives to ensure loans they sell are affordable; and regulators face limits on their ability to oversee a fragmented subprime origination market. These circumstances appear to warrant imposing a new national legal standard on subprime lenders to help ensure that consumers receive mortgage loans they can afford to repay, and help prevent the equity-stripping abuses that unaffordable loans facilitate. Adopting this standard under authority of HOEPA would ensure that it applied uniformly to all originators and provide consumers an opportunity to redress wrongs through civil actions to the extent authorized by TILA. As explained in the next part, substantial information supplied to the Board through several public hearings confirms the need for new HOEPA rules.

III. The Board's HOEPA Hearings

A. Home Ownership and Equity Protection Act (HOEPA)

The Board has recently held extensive public hearings on consumer protection issues in the mortgage market, including the subprime sector. These hearings were held pursuant to the Home Ownership and Equity Protection Act (HOEPA), which directs the Board to hold public hearings periodically on the home equity lending market and the adequacy of existing law for protecting the interests of consumers, particularly low income consumers. HOEPA imposes substantive restrictions, and special pre-closing disclosures, on particularly high-cost refinancings and home equity loans (''HOEPA loans'').[23] These restrictions include limitations on prepayment penalties and ''balloon payment'' loans, and prohibitions of negative amortization and of engaging in a pattern or practice of lending based on the collateral without regard to repayment ability.

When it enacted HOEPA, Congress granted the Board authority, codified in TILA Section 129(l), to create exemptions to HOEPA's restrictions and to expand its protections. 15 U.S.C. 1639(l). Under TILA Section 129(l)(1), the Board may create exemptions to HOEPA's restrictions as needed to keep responsible credit available; and under TILA Section 129(l)(2), the Board may adopt new or expanded restrictions as needed to protect consumers from unfairness, deception, or evasion of HOEPA. In HOEPA Section 158, Congress directed the Board to monitor changes in the home equity market through regular public hearings.

Hearings the Board held in 2000 led the Board to expand HOEPA's protections in December 2001.[24] Those rules, which took effect in 2002, lowered HOEPA's rate trigger, expanded its fee trigger to include single-premium credit insurance, added an anti-''flipping'' restriction, and improved the special pre-closing disclosure.

B. Summary of 2006 Hearings

In the summer of 2006, the Board held four hearings in four cities on three broad topics: (1) The impact of the 2002 HOEPA rule changes on predatory lending practices, as well as the effects on consumers of state and local predatory lending laws; (2) nontraditional mortgage products and reverse mortgages; and (3) informed consumer choice in the subprime market. Hearing panelists included mortgage lenders and brokers, credit ratings agencies, real estate agents, consumer advocates, community development groups, housing counselors, academicians, researchers, and state and federal government officials. In addition, consumers, housing counselors, brokers, and other individuals made brief statements at the hearings during an ''open mike'' period. In all, 67 individuals testified on panels and 54 comment letters were submitted to the Board.

Consumer advocates and some state officials stated that HOEPA is generally effective in preventing abusive terms in loans subject to the HOEPA price triggers. They noted, however, that very

[22] Data reported by Wholesale Access Mortgage Research and Consulting, Inc. Available at *http://www.wholesaleaccess.com/8-17-07-prs.shtml; http://www.wholesaleaccess.com/7_28_mbkr.shtml.*

[23] HOEPA loans are closed-end, non-purchase money mortgages secured by a consumer's principal dwelling (other than a reverse mortgage) where either: (a) *The* APR at consummation will exceed the yield on Treasury securities of comparable maturity by more than 8 percentage points for first-lien loans, or 10 percentage points for subordinate-lien loans; or (b) the total points and fees payable by the consumer at or before closing exceed the greater of 8 percent of the total loan amount, or $547 for 2007 (adjusted annually).

[24] Truth in Lending, 66 FR 65604, 65608, Dec. 20, 2001.

few loans are made with rates or fees at or above the HOEPA triggers, and some advocated that Congress lower them. Consumer advocates and state officials also urged regulators and Congress to curb abusive practices in the origination of loans that do not meet HOEPA's price triggers.

Consumer advocates identified several particular areas of concern. They urged the Board to prohibit or restrict certain loan features or terms, such as prepayment penalties, and underwriting practices such as ''stated income'' or ''low documentation'' (''low doc'') loans for which the borrower's income is not documented or verified. They also expressed concern about aggressive marketing practices such as steering borrowers to higher-cost loans by emphasizing initial low monthly payments based on an introductory rate without adequately explaining that the consumer will owe considerably higher monthly payments after the introductory rate expires.

Some consumer advocates stated that brokers and lenders should be held to a higher duty such as a duty of good faith and fair dealing or a duty to make only loans suitable for the borrower. These advocates also urged the Board to ban ''yield spread premiums,'' payments that brokers receive from the lender at closing for delivering a loan with an interest rate that is higher than the lender's ''buy rate,'' because they provide brokers an incentive to increase consumers' interest rates. They argued that such steps would align reality with consumers' perceptions that brokers serve their best interests. Consumer advocates also expressed concerns that brokers, lenders, and others may coerce appraisers to misrepresent the value of a dwelling; and that servicers may charge consumers unwarranted fees and in some cases make it difficult for consumers who are in default to avoid foreclosure.

Industry panelists and commenters, on the other hand, expressed concern that state predatory lending laws may reduce the availability of credit for some subprime borrowers. Most industry commenters opposed prohibiting stated income loans, prepayment penalties, or other loan terms, asserting that this approach would harm borrowers more than help them. They urged the Board and other regulators to focus instead on enforcing existing laws to remove ''bad actors'' from the market. Some lenders indicated, however, that restrictions on certain features or practices might be appropriate if the restrictions were clear and narrow. Industry commenters also stated that subjective suitability standards would create uncertainties for brokers and lenders and subject them to excessive litigation risk.

C. Summary of June 2007 Hearing

In light of the information received at the 2006 hearings and the rise in defaults that began soon after, the Board held an additional hearing in June 2007 to explore how it could use its authority under HOEPA to prevent abusive lending practices in the subprime market while still preserving responsible subprime lending. The Board focused the hearing on four specific areas: Lenders' determination of borrowers' repayment ability; ''stated income'' and ''low doc'' lending; the lack of escrows in the subprime market relative to the prime market; and the high frequency of prepayment penalties in the subprime market.

At the hearing, the Board heard from 16 panelists representing consumers, mortgage lenders, mortgage brokers, and state government officials, as well as from academicians. The Board also received almost 100 written comments after the hearing from an equally diverse group.

Industry representatives acknowledged concerns with recent lending practices but urged the Board to address most of these concerns through supervisory guidance rather than regulations under HOEPA. They maintained that supervisory guidance, unlike regulation, is flexible enough to preserve access to responsible credit. They also suggested that supervisory guidance issued recently regarding nontraditional mortgages and subprime lending, as well as market self-correction, have reduced the need for new regulations. Industry representatives support improving mortgage disclosures to help consumers avoid abusive loans. They urged that any substantive rules adopted by the Board be clearly drawn to limit uncertainty and narrowly drawn to avoid unduly restricting credit.

In contrast, consumer advocates, state and local officials, and Members of Congress urged the Board to adopt regulations under HOEPA. They acknowledged a proper place for guidance but contended that recent problems indicate the need for requirements enforceable by borrowers through civil actions, which HOEPA enables and guidance does not. They also expressed concern that less responsible, less closely supervised lenders are not subject to the guidance and that there is limited enforcement of existing laws for these entities. Consumer advocates and others welcomed improved disclosures but insisted they would not prevent abusive lending. More detailed accounts of the testimony and letters are provided below in the context of specific issues the Board is proposing to address.

D. Congressional Hearings

Congress has also held a number of hearings in the past year about consumer protection concerns in the mortgage market.[25] In these hearings, Congress has heard testimony from individual consumers, representatives of consumer and community groups, representatives of financial and mortgage industry groups and federal and state officials. These hearings have focused on rising subprime foreclosure rates and the extent to which lending practices have contributed to them.

Consumer and community group representatives testified that certain lending terms or practices, such as hybrid adjustable-rate mortgages, prepayment penalties, low or no documentation loans, lack of escrows for taxes and insurance, and failure to consider the consumer's ability to repay have contributed to foreclosures. In addition, these witnesses testified that consumers often believe that mortgage brokers represent their interests and shop on their behalf for the best loan terms. As a result, they argue that consumers do not shop independently to ensure that they are getting the best terms for which they qualify. They also

[25] *E.g.*, *Progress in Administration and Other Efforts to Coordinate and Enhance Mortgage Foreclosure Prevention: Hearing before the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *Legislative Proposals on Reforming Mortgage Practices: Hearing before the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *Legislative and Regulatory Options for Minimizing and Mitigating Mortgage Foreclosures: Hearing before the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *Ending Mortgage Abuse: Safeguarding Homebuyers: Hearing before the S. Subcomm. on Hous., Transp., and Cmty. Dev. of the S. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. (2007); *Improving Federal Consumer Protection in Financial Services: Hearing before the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *The Role of the Secondary Market in Subprime Mortgage Lending: Hearing before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *Possible Responses to Rising Mortgage Foreclosures: Hearing before the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *Subprime Mortgage Market Turmoil: Examining the Role of Securitization: Hearing before the Subcomm. on Secs., Ins., and Inv. of the S. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. (2007); *Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Financial Institutions: Hearing before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *Mortgage Market Turmoil: Causes and Consequences, Hearing before the S. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. (2007); *Preserving the American Dream: Predatory Lending Practices and Home Foreclosures, Hearing before the S. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. (2007).

testified that, because originators sell most loans into the secondary market and do not share the risk of default, brokers and lenders have less incentive to ensure consumers can afford their loans.

Financial services and mortgage industry representatives testified that consumers need better disclosures of their loan terms, but that substantive restrictions on subprime loan terms would risk reducing access to credit for some borrowers. In addition, these witnesses testified that applying a fiduciary duty to the subprime market, such as requiring that a loan be in the borrower's best interest, would introduce subjective standards that would significantly increase compliance and litigation risk. According to these witnesses, some lenders would be less willing to offer loans in the subprime market, making it harder for some consumers to get loans.

IV. Inter-Agency Supervisory Guidance

In December 2005, the Board and the other federal banking agencies responded to concerns about the rapid growth of nontraditional mortgages in the previous two years by proposing supervisory guidance. Nontraditional mortgages are mortgages that allow the borrower to defer repayment of principal and sometimes interest. The guidance advised institutions of the need to reduce ''risk layering'' practices with respect to these products, such as failing to document income or lending nearly the full appraised value of the home. The proposal, and the final guidance issued in September 2006, specifically advised lenders that layering risks in nontraditional mortgage loans to subprime borrowers may significantly increase risks to borrowers as well as institutions.[26]

The Board and the other federal banking agencies addressed concerns about the subprime market more broadly in March 2007 with a proposal addressing the heightened risks to consumers and institutions of ARMs with two or three-year ''teaser'' rates followed by substantial increases in the rate and payment. The guidance, finalized in June, sets out the standards institutions should follow to ensure borrowers in the subprime market obtain loans they can afford to repay.[27] Among other steps, the guidance advises lenders to (1) use the fully-indexed rate and fully-amortizing payment when qualifying borrowers for loans with adjustable rates and potentially non-amortizing payments; (2) limit stated income and reduced documentation loans to cases where mitigating factors clearly minimize the need for full documentation of income; (3) provide that prepayment penalty clauses expire a reasonable period before reset, typically at least 60 days.

The Conference of State Bank Supervisors (CSBS) and American Association of Residential Mortgage Regulators (AARMR) issued parallel statements for state supervisors to use with state-supervised entities, and many states have adopted the statements.

The guidance issued by the federal banking agencies has helped to promote safety and soundness and protect consumers in the subprime market. Guidance, however, is not necessarily implemented uniformly by all originators. Originators who are not subject to routine examination and supervision may not adhere to guidance as closely as originators who are. Guidance also does not provide individual consumers who have suffered harm because of abusive lending practices an opportunity for redress. The new and expanded consumer protections that the Board is proposing would apply uniformly to all creditors and be enforceable by federal and state supervisory and enforcement agencies and in many cases by borrowers.

V. Legal Authority

A. The Board's Authority Under TILA Section 129(l)(2)

The substantive limitations in new proposed §§ 226.35 and 226.36 and corresponding revisions proposed for existing § 226.32, as well as proposed restrictions on misleading and deceptive advertisements, would be based on the Board's authority under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2). That provision gives the Board authority to prohibit acts or practices in connection with:

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

The authority granted to the Board under Section 129(l)(2), 15 U.S.C. 1639(l)(2), is broad both in absolute terms and relative to HOEPA's statutory prohibitions. For example, this authority reaches mortgage loans with rates and fees that do not meet HOEPA's rate or fee trigger in TILA Section 103(aa), 15 U.S.C. 1602(aa), as well as types of mortgage loans not covered under that section, such as home purchase loans. Nor is the Board's authority limited to regulating specific contractual terms of mortgage loan agreements; it extends to regulating loan-related practices generally, within the standards set forth in the statute. Moreover, while HOEPA's current restrictions apply only to creditors and only to loan terms or lending practices, TILA Section 129(l)(2) is not limited to creditors, nor is it limited to loan terms or lending practices. *See* 15 U.S.C. 1639(l)(2). It authorizes protections against unfair or deceptive practices when such practices are ''in connection with mortgage loans,'' and it authorizes protections against abusive practices ''in connection with refinancing of mortgage loans.''

HOEPA does not set forth a standard for what is unfair or deceptive, but the Conference Report for HOEPA indicates that, in determining whether a practice in connection with mortgage loans is unfair or deceptive, the Board should look to the standards employed for interpreting state unfair and deceptive trade practices acts and the Federal Trade Commission Act, Section 5(a), 15 U.S.C. 45(a).[28]

Congress has codified standards developed by the Federal Trade Commission for determining whether acts or practices are unfair under Section 5(a), 15 U.S.C. 45(a).[29] Under the Act, an act or practice is unfair when it causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. In addition, in determining whether an act or practice is unfair, the FTC is permitted to consider established public policies, but public policy considerations may not serve as the primary basis for an unfairness determination.[30]

The FTC has interpreted these standards to mean that consumer injury is the central focus of any inquiry regarding unfairness.[31] Consumer injury may be substantial if it imposes a small harm on a large number of consumers, or if it raises a significant risk of

[26] Interagency Guidance on Nontraditional Mortgage Product Risks, 71 FR 58609, Oct. 4, 2006.

[27] Statement on Subprime Mortgage Lending, 72 FR 37569, Jul. 10, 2007.

[28] H.R. Rep. 103–652, at 162 (1994) (Conf. Rep.).

[29] *See* 15 U.S.C. 45(n); Letter from FTC to the Hon. Wendell H. Ford and the Hon. John C. Danforth (Dec. 17, 1980).

[30] 15 U.S.C. 45(n).

[31] Statement of Basis and Purpose and Regulatory Analysis, Credit Practices Rule (Credit Practices Rule), 42 FR 7740, 7743 March 1, 1984.

concrete harm.[32] The FTC looks to whether an act or practice is injurious in its net effects.[33] The agency has also observed that an unfair act or practice will almost always reflect a market failure or market imperfection that prevents the forces of supply and demand from maximizing benefits and minimizing costs.[34] In evaluating unfairness, the FTC looks to whether consumers' free market decisions are unjustifiably hindered.[35]

The FTC has also adopted standards for determining whether an act or practice is deceptive (though these standards, unlike unfairness standards, have not been incorporated into the FTC Act).[36] First, there must be a representation, omission or practice that is likely to mislead the consumer. Second, the act or practice is examined from the perspective of a consumer acting reasonably in the circumstances. Third, the representation, omission, or practice must be material. That is, it must be likely to affect the consumer's conduct or decision with regard to a product or service.[37]

Many states also have adopted statutes prohibiting unfair or deceptive acts or practices, and these statutes employ a variety of standards, many of them different from the standards currently applied to the FTC Act. A number of states follow an unfairness standard formerly used by the FTC. Under this standard, an act or practice is unfair where it offends public policy; or is immoral, unethical, oppressive, or unscrupulous; and causes substantial injury to consumers.[38] Some states require that a finding of deception be supported by a showing of intent to deceive, while other states only require showing that an act or practice is capable of being interpreted in a misleading way.[39]

In proposing rules under TILA Section 129(l)(2)(A), 15 U.S.C. 1639(l)(2)(A), the Board has considered the standards currently applied to the FTC Act's prohibition against unfair or deceptive acts or practices, as well as the standards applied to similar state statutes.

B. The Board's Authority Under TILA Section 105(a)

Other aspects of this proposal are based on the Board's general authority under TILA Section 105(a) to prescribe regulations necessary or proper to carry out TILA's purposes. 15 U.S.C. 1604(a). This section is the basis for the proposal to require early disclosures for residential mortgage transactions as well as many of the proposals to improve advertising disclosures. These proposals are intended to carry out TILA's purposes of informing consumers about their credit terms and helping them shop for credit. See TILA Section 102, 15 U.S.C. 1603.

VI. Proposed Definition of ''Higher-Priced Mortgage Loan''

A. Overview

The Board proposes to extend certain consumer protections to a subset of consumer residential mortgage loans referred to as ''higher-priced mortgage loans.'' A creditor would be prohibited from engaging in a pattern or practice of making higher-priced mortgage loans based on the collateral without regard to repayment ability. A creditor would also be prohibited from making an individual higher-priced mortgage loan without: Verifying the consumer income and assets the creditor relied upon to make the loan; and establishing an escrow account for taxes and insurance. In addition, a higher-priced mortgage loan would not be permitted to have a prepayment penalty except under certain conditions. Finally, a creditor would be prohibited from structuring a closed-end mortgage loan as an open-end line of credit for the purpose of evading the restrictions on higher-priced mortgage loans, which would not apply to open-end lines of credit.

This part VI discusses the proposed definition of a ''higher priced mortgage loan'' and a discussion of the specific protections that would apply to these loans follows in part VII. The Board is proposing to apply certain other restrictions to closed-end consumer mortgage loans secured by the consumer's principal dwelling without regard to loan price. These restrictions are discussed separately in part VIII.

Higher-priced mortgage loans would be defined as consumer credit transactions secured by the consumer's principal dwelling for which the APR on the loan exceeds the yield on comparable Treasury securities by at least three percentage points for first-lien loans, or five percentage points for subordinate lien loans. The proposed definition would include home purchase loans, refinancings of loans, and home equity loans. The definition would exclude home equity lines of credit (''HELOCs''). In addition, there would be exclusions for reverse mortgages, construction-only loans, and bridge loans.

The definition of ''higher-priced mortgage loans'' would appear in proposed § 226.35(a). Such loans would be subject to the restrictions and requirements in § 226.35(b) concerning repayment ability, income verification, prepayment penalties, escrows, and evasion, except that subordinate-lien higher-priced mortgage loans would not be subject to the escrow requirement.

B. Public Comment on the Scope of New HOEPA Rules

The June 14, 2007 hearing notice solicited comment on the following questions concerning coverage:

- Whether terms or practices discussed in the hearing notice should be prohibited or restricted for all mortgage loans, or only for loans offered to subprime borrowers?
- Whether terms or practices should be prohibited or restricted for loans to first-time homebuyers, home purchase loans, or refinancings and home equity loans?
- Whether terms or practices should be prohibited or restricted only for certain products, such as adjustable-rate mortgages or nontraditional mortgages?

Many commenters addressed the scope of any rules the Board might propose. Some consumer and community groups favored applying some or all prohibitions to the entire mortgage market, though other groups recommended that certain protections (e.g., for repayment ability) be applied to the entire market and others (e.g., for escrows) only to subprime and nontraditional loans. In general, financial institutions and financial services groups maintained that new rules should not be applied to the entire market.

Most commenters suggested that, to the extent the Board targets subprime

[32] Letter from Commissioners of the FTC to the Hon. Wendell H. Ford, Chairman, and the Hon. John C. Danforth, Ranking Minority Member, Consumer Subcomm. of the H. Comm. on Commerce, Science, and Transp., n.12 (Dec. 17, 1980).

[33] Credit Practices Rule, 42 FR at 7744.

[34] *Credit Practices Rule at 7744.*

[35] *Credit Practices Rule at 7744.*

[36] Letter from James C. Miller III, Chairman, FTC to the Hon. John D. Dingell, Chairman, H. Comm. on Energy and Commerce (Dingell Letter) (Oct. 14, 1983).

[37] Dingell Letter at 1–2.

[38] *See, e.g., Kenai Chrysler Ctr., Inc.* v. *Denison,* 167 P.3d 1240, 1255 (2007) (quoting *FTC* v. *Sperry & Hutchinson Co.,* 405 U.S. 233, 244–45 n.5 (1972)); *State* v. *Moran,* 151 N.H. 450, 452, 861 A.2d 763, 755–56 (2004) (concurrently applying the FTC's former test and a test under which an act or practice is unfair or deceptive if ''the objectionable conduct * * * attain[s] a level of rascality that would raise an eyebrow of someone inured to the rough and tumble of the world of commerce.'') (citation omitted); *Robinson* v. *Toyota Motor Credit Corp.,* 201 Ill. 2d 403, 417–418, 775 N.E.2d 951, 961–62 (2002) (quoting 405 U.S. at 244–45 n.5).

[39] *Compare Robinson,* 201 Ill. 2d at 417 (showing of intent to deceive required under Illinois Consumer Fraud Act) *with Kenai Chrysler Ctr.,* 167 P.3d at 1255 (no showing of intent to deceive required under Alaska Unfair Trade Practices Act).

loans, it do so based on loan characteristics rather than borrower characteristics such as credit score. Some commenters proposed that coverage be determined by a loan's annual percentage rate (APR) and suggested various approaches based on lender reporting of ''higher-priced loans'' under Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). Several industry commenters, however, pointed out drawbacks of using an approach based on HMDA reporting and advocated instead that the Board cover only loans with ''payment shock.''

C. General Principles Governing the Board's Determination of Coverage

Four main principles will guide the Board's determination of appropriate coverage. First, new regulations should be applied as broadly as needed to protect consumers from actual or potential injury, but not so broadly that the costs, including the always-present risk of unintended consequences, would clearly outweigh the benefits. Evidence that consumers have actually been injured by a particular practice in a particular market segment is important to determining proper coverage. Protection may also be needed in a particular segment, however, to prevent potential future injury in that segment or to limit adverse effects should lenders circumvent protections applied to another segment.

Second, the most practical and effective way to protect borrowers is to apply protections based on loan characteristics, rather than borrower characteristics. Identifying a class of protected borrowers would present operational difficulties and other problems. For example, it is common to distinguish borrowers by credit score, with lower-scoring borrowers generally considered to be at higher risk of injury in the mortgage market. Defining the protected field as lower-scoring consumers would fail to protect higher-scoring consumers ''steered'' to loans meant for lower-scoring consumers. Moreover, the market uses different commercial scores, and choosing a particular score as the benchmark for a regulation could give unfair advantage to the company that provides that score.

Third, the rule identifying higher-priced loans should be as simple as reasonably possible, consistent with protecting consumers and minimizing costs. For the sake of simplicity, the same coverage rule should apply to all new protections except where the benefit of tailoring coverage criteria to specific protections outweighs the increased complexity.

Fourth, the rule should give lenders a reasonable degree of certainty during the application process regarding whether a transaction, when completed, will be covered by a particular protection. For some protections, reasonable certainty may be needed early in the application process; for other protections, it may not be needed until later. Reasonable certainty does not mean complete certainty. A rule that would provide lenders complete certainty about coverage early in the application process is likely not achievable.

D. Types of Loans Proposed To Be Covered Under § 226.35

The Board's proposed definition of ''higher-priced mortgage loan'' has two main aspects. The first aspect is loan type—the definition includes certain types of loans (such as home purchase loans) and excludes others (such as HELOCs). The second aspect is loan price—the definition includes only loans with APRs exceeding specified thresholds. The first aspect of the definition, loan type, is discussed immediately below, and the second is discussed thereafter.

The Board proposes to apply the protections of § 226.35 to first-lien, as well as subordinate-lien, closed-end mortgage loans secured by the consumer's principal dwelling, including home purchase loans, refinancings of loans, and home equity loans. The proposed definition would not cover loans that do not have primarily a consumer purpose, such as loans for real estate investment. The proposed definition also would not cover HELOCs, reverse mortgages, construction-only loans, or bridge loans.

Coverage of Home Purchase Loans, Refinancings, and Home Equity Loans

The statutory protections for HOEPA loans are generally limited to closed-end refinancings and home equity loans. *See* TILA Section 103(aa), 15 U.S.C. 1602(aa). The Board proposes to apply the protections of § 226.35 to loans of these types, which have historically presented the greatest risk to consumers. These loans are often made to consumers who have home equity and, therefore, have an existing asset at risk. These loans also can be marketed aggressively by originators to homeowners who may not benefit from them and who, if responding to the marketing and not shopping independently, may have limited information about their options.

The Board proposes to use its authority under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), to cover home purchase loans as well. Covering only refinancings of home purchase loans would fail to protect consumers adequately. From 2003 to 2006, 44 percent of the higher-risk ARMs that came to dominate the subprime market in recent years were extended to consumers to purchase a home.[40] Delinquencies on subprime ARMs used for home purchase have risen sharply just as they have for refinancings. Moreover, comments and testimony at the Board's hearings indicate that the problems with abusive lending practices are not confined to refinancings and home equity loans.

Furthermore, consumers who are seeking home purchase loans can face unique constraints on their ability to make decisions. First-time homebuyers are likely unfamiliar with the mortgage market. Homebuyers generally are primarily focused on acquiring a new home, arranging to move into it, and making other life plans related to the move, such as placing their children in new schools. These matters can occupy much of the time and attention consumers might otherwise devote to shopping for a loan and deciding what loan to accept. Moreover, even if the consumer comes to understand later in the application process that an offered loan may not be appropriate, the consumer may not be able to reject the loan without risk of abrogating the sales agreement and losing a substantial deposit, as well as disrupting moving plans.

Coverage of Subordinate-Lien Loans

The Board is proposing to apply the proposed new protections—with the exception of the requirement to establish escrows—to subordinate-lien loans. (The reasons for this exception are discussed below under part VII.D.) The Board seeks comment on whether other exceptions would be appropriate. For example, should the Board limit coverage of all or some of the proposed restrictions to certain kinds of subordinate-lien loans such as ''piggy backs'' to first-lien loans, or subordinate-lien loans that are larger than the first-lien loan?

Limitation to Loans Secured by Principal Dwelling; Exclusion of Loans for Investment

The Board is proposing to limit the protections in proposed § 226.35 to loans secured by the consumer's principal dwelling. The Board's primary concern is to ensure that consumers not lose the homes they principally occupy

[40] Figure calculated from First American LoanPerformance data.

because of unfair, abusive, or deceptive lending practices. The inevitable costs of new regulation, including potential unintended consequences, can most clearly be justified when people's principal homes are at stake.

Limiting the proposed protections to loans secured by the principal dwelling would have the effect of excluding many, but not all, loans to purchase second homes. A loan to a consumer to purchase a second home, for example, would not be covered by these protections if the loan was secured only by the second home or by another dwelling (such as an investment property) other than the consumer's principal dwelling. Such a loan would, however, be covered if it was instead secured by the consumer's principal dwelling.

Limiting the proposed protections to loans secured by the principal dwelling—and to loans having primarily a consumer purpose—would also have the effect of excluding loans primarily for a real estate investment purpose. This exclusion is consistent with TILA's focus on consumer concerns and its exclusion in Section 104 of credit primarily for business, commercial, or agricultural purposes. *See* 15 U.S.C. 1603(1). Real estate investors are expected to be more sophisticated than ordinary consumers about the real estate financing process and to have more experience with it, especially if they invest in several properties. Accordingly, the need to protect investors is not clear, and in any event is likely not sufficient to justify the potential unintended consequences of imposing restrictions, with civil liability if they are violated, on the financing of real estate investment transactions.

The Board shares concerns that individuals who invest in residential real estate and do not pay their mortgage obligations put tenants at risk of eviction in the event of foreclosure. Regulating the rights of landlords and tenants, however, is traditionally a matter for state and local law. The Board believes that state and local law could better address this particular tenant protection concern than a Board regulation.

Exclusion of HELOCs

The Board proposes to exclude HELOCs from the proposed protections. These transactions do not appear to present as clear a need for new regulations as closed-end transactions. Most originators of HELOCs hold them in portfolio rather than sell them, which aligns these originators' interests in loan performance more closely with their borrowers' interests. In addition, TILA and Regulation Z provide borrowers special protections for HELOCs such as restrictions on changing plan terms. And, unlike originations of higher-priced closed-end mortgage loans, HELOC originations are concentrated in the banking and thrift industries, where the federal banking agencies can use supervisory authorities to protect borrowers. For example, when inadequate underwriting of HELOCs unduly increased risks to originators and consumers several years ago, the agencies responded with guidance.[41] For these reasons, the Board is not proposing to cover HELOCs.

The Board recognizes, however, that HELOCs may represent a risk of circumvention. Creditors may seek to evade limitations on closed-end transactions by structuring such transactions as open-end transactions. In proposed § 226.35(b)(5), discussed below in part VII.F., the Board proposes to prohibit structuring a closed-end loan as an open-end transaction for the purpose of evading the new rules in § 226.35. To the extent it may instead be appropriate to apply those rules directly to HELOCs, the Board seeks comment on how an APR threshold for HELOCs could be set to achieve the objectives, discussed further in subpart E., of covering the subprime market and generally excluding the prime market.

Exclusion of Reverse Mortgages and Construction-Only Loans

The Board proposes to exclude reverse mortgages and construction-only loans from the new protections in § 226.35(b). A reverse mortgage is defined in current § 226.33(a), and the proposal would retain this definition. The Board heard from panelists about reverse mortgages at its 2006 HOEPA hearings and has not identified significant abuses in the reverse mortgage market. Moreover, reverse mortgages are unique transactions that present unique risks that are currently addressed by Regulation Z § 226.33. At an appropriate time, the Board will review § 226.33 and consider whether new or different protections are needed for reverse mortgages.

The Board would also exclude from § 226.35's protections a construction-only loan, defined as a loan solely for the purpose of financing the initial construction of a dwelling, consistent with the definition of a ''residential mortgage transaction'' in § 226.2(a)(24). A construction-only loan would not include the permanent financing that replaces a construction loan. Construction-only loans do not appear to present the same risk of consumer abuse as other loans the proposal would cover. The permanent financing, or a new home-secured loan following construction, would be covered by proposed § 226.35. Applying § 226.35 to construction-only loans, which generally have higher interest rates than the permanent financing, could hinder some borrowers' access to construction financing without meaningfully enhancing consumer protection.

Exclusion of Bridge Loans

Proposed § 226.35(a)(5) would exempt from § 226.35 temporary or ''bridge loans'' with a term of no more than twelve months. The regulation would give as an example a loan that a consumer takes to ''bridge'' between the purchase of a new dwelling and the sale of the consumer's existing dwelling. HOEPA now covers certain bridge loans with rates or fees high enough to make them HOEPA loans. TILA Section 129(l)(1) provides the Board authority to exempt classes of mortgage transactions from HOEPA if the Board finds that the exemption is in the interest of the borrowing public and will apply only to products that maintain and strengthen homeownership and equity protection. 15 U.S.C. 1639(l)(2). The Board believes a narrow exemption from HOEPA for bridge loans would be in borrowers' interest and support homeownership. The Board seeks comment on the proposed exemption.

E. Proposed APR Trigger for § 226.35

Overview

The Board proposes to use an APR trigger to define the range of transactions that would be covered by the protections of proposed § 226.35. The Board seeks to set the trigger at a level that would capture the subprime market but generally exclude the prime market. There is, however, inherent uncertainty as to what level would achieve these objectives. The Board believes that it may be appropriate, in the face of this uncertainty, to err on the side of covering somewhat more than the subprime market. Based on this approach, the Board proposes a threshold of three percentage points above the comparable Treasury security for first-lien loans, or five percentage points for subordinate-lien loans. Based on available data, it appears that this threshold would capture at least the

[41] Interagency Credit Risk Guidance for Home Equity Lending, May 16, 2005.

Available at *http://www.federalreserve.gov/boarddocs/srletters/2005/sr0511a1.pdf.*

Addendum to Credit Risk Guidance for Home Equity Lending, Sept. 29, 2006. Available at *http://www.federalreserve.gov/BoardDocs/SRLetters/2006/SR0615a3.pdf.*

higher-priced end of the alt-A market. The Board seeks comment, and solicits data, on the extent to which the threshold would cover the alt-A market, and on the benefits and costs, including any potential unintended consequences for consumers, of applying any or all of the protections in § 226.35 to the alt-A market to the extent it would be covered. The Board also seeks comment on whether a different threshold, such as four percentage points for first-lien loans (and six percentage points for subordinate-lien loans), would better satisfy the objectives of covering the subprime market, excluding the prime market, and avoiding unintended consequences for consumers in the alt-A market.

Reasons To Use APR

The APR corresponds closely to credit risk, that is, the risk of default as well as the closely related risks of serious delinquency and foreclosure. Loans with higher APRs generally have higher credit risks, whatever the source of the risk might be—weaker borrower credit histories, higher borrower debt-to-income ratios, higher loan-to-value ratios, less complete income or asset documentation, less traditional loan terms or payment schedules, or combinations of these or other risk factors. Since disclosing an APR has long been required by TILA, the figure is also very familiar and readily available to creditors and consumers. Therefore, the Board believes it appropriate to use a loan's APR to identify loans having a high enough credit risk to warrant the protections of proposed § 226.35.

The APR for two loans with identical risk characteristics can be different at different times solely because of market changes in mortgage rates. The Board proposes to control for such market changes by comparing a loan's APR to the yield on the comparable Treasury security. This would be similar, but not identical, to the approach HOEPA uses currently to identify HOEPA-covered loans, *see* TILA Section 103(aa), 15 U.S.C. 1602(aa), and § 226.32(a), and Regulation C uses to identify higher-priced loans reportable under HMDA, *see* 12 CFR 203.4(a)(12). The Board is aware of concerns that the method that these regulations use to match mortgage loans to Treasuries leads to some inaccuracy in coverage and makes coverage vary with changes in the yield curve (the relationship between short-term and long-term interest rates). As discussed in more detail below, the Board is proposing to address these concerns in the context of § 226.35.

Coverage Objectives

The Board set forth above a general principle that new regulations should be applied as broadly as needed to protect consumers from actual or potential injury, but not so broadly that the costs, including the always-present risk of unintended consequences, would clearly outweigh the benefits. Consistent with this principle, the Board believes that the APR threshold should satisfy two objectives. It should ensure that subprime loans are covered. Second, it should also generally exclude prime loans.

The subprime market should be covered because it is, by definition, the market with the highest credit risk. There are of course variations in risk within the subprime market. For example, delinquencies on fixed-rate subprime mortgages have been lower in recent years than on adjustable-rate subprime mortgages. It may not be practical or effective, however, to target certain loans in the subprime market for coverage while excluding others. Such a rule would be more complex and possibly require frequent updating as products evolved. Moreover, market imperfections discussed in part II.C.—the subprime market's lack of transparency and potentially inadequate creditor incentives to make only loans that consumers can repay—affect the subprime market as a whole.

There are two principal reasons why the Board seeks to exclude the prime market from § 226.35. First, there is limited evidence that the problems addressed in § 226.35, such as lending without regard to repayment ability, have been significant in the prime market or gone unaddressed when they have on occasion arisen. By nature, loans in the prime market have a lower credit risk, as seen in the relatively low default and delinquency rates for prime loans compared to sharply increasing rates for subprime loans since 2005. Moreover, the prime market is more transparent and competitive, characteristics that make it less likely a creditor can sustain an unfair, abusive, or deceptive practice. In addition, borrowers in the prime market are less likely to be under the degree of financial stress that tends to weaken the ability of many borrowers in the subprime market to protect themselves against unfair, abusive, or deceptive practices. To be sure, there have been concerns about the prime market, and this proposal would address some of them. For example, the proposal addresses concerns about coercion of appraisers, untransparent creditor payments to mortgage brokers, and abusive servicing practices.

Second, any undue risks to consumers in the prime market from particular loan terms or lending practices can be adequately addressed through means other than new regulations under HOEPA. Supervisory guidance from the federal agencies influences a large majority of the prime market which, unlike the subprime market, has been dominated by federally supervised institutions.[42] Such guidance affords regulators and institutions alike more flexibility than a regulation, with potentially fewer unintended consequences. In addition, the Government Sponsored Enterprises continue to play a major role in the prime market, and they are accountable to regulators and policy makers for the standards they set for loans they will purchase.[43]

For these reasons, the Board does not believe that substantive restrictions on loan terms or lending practices are warranted in the prime market at this time. The need for such restrictions is not clear and their potential unintended consequences could be significant.

Inherent Uncertainty of Meeting Coverage Objectives

There are three major reasons why it is inherently uncertain which APR threshold would achieve the twin objectives of covering the subprime market and generally excluding the prime market. First, there is no single, precise, and uniform definition of the prime or subprime market, or of a prime or subprime loan. Moreover, the markets are separated by a somewhat loosely defined segment known as the alt-A market, the precise boundaries of which are not clear.

Second, available data sets enable only estimation, not precise calculation, of the empirical relationship between APR and credit risk. A proprietary dataset such as First American LoanPerformance may contain detailed information on loan characteristics, including the contract rate, but lack the APR or sufficient data to derive the APR. Other data must be consulted to estimate APRs based on contract rates. HMDA data contain the APR for higher-priced loans (as adjusted by comparable Treasury securities), but they have little information about credit risk.

[42] According to HMDA data from 2005 and 2006, more than three-quarters of prime, conventional first-lien mortgage loans on owner-occupied properties were made by depository institutions or their affiliates. For this purpose, a loan for which price information was not reported is treated as a prime loan.

[43] According to HMDA data from 2005 and 2006, nearly 30 percent of prime, conventional first-lien mortgage loans on owner-occupied properties were purchased by Fannie Mae or Freddie Mac.

Third, data sets can of course show only the existing or past distribution of loans across market segments, which may change in ways that are difficult to predict. In particular, the distribution could change in response to the Board's imposition of the restrictions in § 226.35, but the likely direction of the change is not clear. A loan's APR is typically not known to a certainty until after the underwriting has been completed, and not until closing if the consumer has not locked the interest rate. Creditors might build in a ''cushion'' against this uncertainty by voluntarily setting their internal thresholds lower than the threshold in the regulation.

Creditors would have a competing incentive to avoid the restrictions, however, by restructuring the prices of potential loans that would have APRs just above the threshold to cause the loans' APRs to come under the threshold. Different combinations of interest rate and points that are economically identical for an originator produce different APRs. If proposed § 226.35 were adopted, an originator would have an incentive to achieve a rate-point combination that would bring a loan's APR below the threshold (if the borrower had the resources or equity to pay the points). Moreover, some fees, such as late fees and prepayment penalties, are not included in the APR. Creditors could increase the number or amounts of such fees to maintain a loan's effective price while lowering its APR below the threshold. It is not clear whether the net effect of these competing forces of over-compliance and circumvention would be to capture more, or fewer, loans.

For all of the above reasons, there is inherent uncertainty as to what APR threshold would achieve the objectives of covering the subprime market and generally excluding the prime market.

The Alt-A Market

In the face of this uncertainty, deciding on an APR threshold calls for judgment. The Board believes it may be appropriate to err on the side of covering somewhat more than the subprime market. In effect, this could mean covering part of the alt-A market, a possibility that merits special consideration.

The alt-A market is generally understood to be for borrowers who typically have higher credit scores than subprime borrowers but still pose more risk than prime borrowers because they make small down payments or do not document their incomes, or for other reasons. The definition of this market is not precise, however. Moreover, the size and character of this market segment have changed markedly in a relatively short period. According to one source, it was 2 percent of residential mortgage originations in 2003 and 13 percent in 2006.[44] At least part of this growth was due to increasing flexibility of underwriting standards. For example, in 2006, 80 percent of loans originated for alt-A securitized pools were underwritten without full documentation of income, compared to about 60 percent from 2000 to 2004.[45] At the same time, nontraditional mortgages allowing borrowers to defer principal, or both principal and interest, also expanded, reaching 78 percent of alt-A originations in 2006.[46]

The Board recognizes that risks to consumers in the alt-A market are lower than risks in the subprime market. The Board believes, however, that it may be appropriate to cover at least part of the alt-A market with the protections of § 226.35. Because of the inherent uncertainties in setting an APR threshold discussed above, covering part of the alt-A market may be necessary to ensure consistent coverage of the subprime market. Moreover, to the extent § 226.35 were to cover the higher-priced end of the alt-A market, where several risks may be layered, the regulation may benefit consumers more than it would cost them. For example, applying an income verification requirement to the riskier part of the alt-A market could ameliorate injuries to consumers from lending based on inflated incomes without necessarily depriving consumers of access to credit, if they are able to document their incomes as § 226.35(b)(2) would require. Prohibiting lending without regard to repayment ability in this market slice could reduce the risk to consumers from ''payment shock'' on nontraditional loans. At the same time, the Board recognizes the potential for unintended consequences if § 226.35 restrictions were to cover part of the alt-A market and seeks to minimize those consequences.

The Proposed Thresholds of 3 and 5 Percentage Points

Based on the foregoing considerations, the Board is proposing to set the APR threshold for a loan at three percentage points above the comparable Treasury security, or five percentage points in the case of a subordinate-lien loan. Available data indicate that this threshold would capture the subprime market but generally exclude the prime market. In each of the last two years, the percentage of the first-lien mortgage market Regulation C has captured as higher-priced using a threshold of three percentage points has been greater than the percentage of the total market originations that one industry source has estimated to be subprime (25 percent vs. 20 percent in 2005; 28 percent vs. 20 percent in 2006).[47] Regulation C is not thought, however, to have reached the prime market. Rather, in both years it reached into the alt-A market, which the same source estimated to be 12 percent in 2005 and 13 percent in 2006. In 2004, Regulation C captured a significantly smaller part of the market than an industry estimate of the subprime market (11 percent vs. 19 percent), but that year's HMDA data were somewhat anomalous.[48]

The Board does not have data indicating how closely the proposed threshold of five percentage points for subordinate-lien loans would correspond to the subprime home equity market. It is the Board's understanding, however, that this threshold, which has prevailed in Regulation C since 2004, has been at least roughly accurate.

Requests for Comment

The Board seeks comment, and supporting data, on whether different thresholds would better satisfy the objectives of covering the subprime market and generally excluding the prime market. The Board seeks comment and data both as to first-lien loans and as to subordinate-lien loans; and both as to home purchase loans and as to refinancings. The Board also seeks comment and supporting data on the extent to which the proposed threshold would cover the alt-A market and, as discussed above, on the costs and benefits of such coverage. Moreover, the Board seeks comment on whether a different threshold than that proposed, such as four percentage points for first-lien loans (and six percentage points for subordinate-lien loans), would better satisfy the objectives of covering the subprime market, excluding the prime market, and avoiding unintended

[44] *IMF 2007 Mortgage Market*, at 4.

[45] Figures calculated from First American LoanPerformance data.

[46] David Liu & Shumin Li, *Alt A Credit—The Other Shoe Drops?*, The MarketPulse The MarketPulse (First American LoanPerformance, Inc., San Francisco, Cal.), Dec. 2006.

[47] For industry estimates see *IMF 2007 Mortgage Market*, at 4.

[48] The principal cause of the reporting deficit was the unusually steep yield curve that characterized 2004. For purposes of proposed § 226.35(a), the Board is proposing to adjust the method that Regulation C uses to calculate the higher-priced loan threshold to reduce, though not eliminate, the effects of yield curve changes on § 226.35's coverage. This proposal is discussed below.

consequences for consumers in the alt-A market.

The Board also seeks comment on the extent to which lenders may set an internal threshold lower than that set forth in the regulation to ensure compliance, and the consequences that could have for consumers. Conversely, the Board seeks comment on the extent of the risk creditors would circumvent the proposed restrictions by charging more fees and lower interest rates to reduce their loans' APRs, and the consequences that could have for consumers. Is this risk significant enough to warrant addressing separately. For example, should the Board adopt a separate fee trigger? What fees would such a trigger include and at what level would it be set? Alternatively, would a general prohibition on manipulating the APR to circumvent the protections of § 226.35 be practicable?

F. Mechanics of the Proposed APR Trigger

Under Regulation C, price information on a closed-end, first-lien loan is reported if the loan's APR exceeds by three or more percentage points (five if the loan is secured by a subordinate lien) the yield on Treasury securities having a comparable period of maturity. A lender uses the yield on Treasury securities as of the 15th day of the preceding month if the rate is set between the 1st and the 14th day of the month, and as of the 15th of the current month if the rate is set on or after the 15th day. Although the Board proposes to use the same numerical thresholds, the Board proposes to use somewhat different rules for matching mortgage loans to Treasury securities.

Matching Loans to Treasury Securities

For purposes of this rulemaking, the Board proposes to use a different approach than Regulation C uses to match loans to Treasury securities, with the intent of reducing effects solely from changes in the interest rate environment. Following the model of HOEPA (TILA Section 103(aa), 15 U.S.C. 1603(aa)), Regulation C compares the APR on a loan to the yield on Treasury securities having a period of maturity comparable to the maturity of the loan. 12 CFR 203.4(a)(12). For example, the APR on a fixed-rate, 30-year loan—the most common loan term in the market—is compared to the yield on a 30-year Treasury security. In actuality, mortgage loans are usually paid off long before they mature, typically in five to ten years. Rates on fixed-rate 30-year mortgage loans, therefore, more closely track yields on Treasury securities having maturities in the range of five to ten years rather than yields on 30-year Treasury securities. Rates on adjustable-rate mortgages more closely track yields on Treasury securities that mature in one to five years, depending in part on the duration of any initial fixed-rate period. As a result, changes in the relationship of short-term rates to long-term rates, known as the yield curve, have affected reporting of higher-priced mortgage loans.

For purposes of the rules proposed here, the Board's goal is to reduce this ''yield curve effect.'' Ideally, each loan would be matched to a Treasury security that corresponds to that loan's expected maturity, which would be determined based on empirical data about prepayment speeds for loans with the same features. It is not practicable, however, to match loans to Treasuries on the basis of the full range of features that may influence prepayment speeds. For the sake of simplicity and predictability, the Board proposes to prescribe rules based on three features: whether the loan is adjustable-rate or fixed-rate; the term of the loan; and the length of any initial fixed-rate period, if the loan is adjustable-rate.

Proposed § 226.35(a) that would match closed-end loans to Treasury securities as follows. First, variable rate transactions with an initial fixed-rate period of more than one year would be matched to Treasuries having a maturity closest to the length of the fixed-rate period (unless the fixed-rate period exceeds seven years, in which case the creditor would use the rules applied to non-variable rate loans). For example, a 30-year ARM having an initial fixed-rate period of five years would be matched to a 5-year Treasury security. Second, variable-rate transactions with an initial fixed-rate period of one year or less would be matched to Treasury security having a maturity of one year. Third, fixed-rate loans would be matched on the basis of loan term in the following way: A fixed-rate loan with a term of 20 years or more would be matched to a 10-year Treasury security; a fixed-rate loan with a term of more than 7 years but less than twenty years would be matched to a 7-year Treasury security; and a fixed-rate loan with a term of seven years or less would be matched to the Treasury security with a maturity closest to the term.

Timing of the Match

The proposal also would differ from Regulation C as to timing. The Treasury security yield that would be used is the yield as of the 15th of the month preceding the month in which the application is received, rather than the 15th of the month before the rate is locked. This would introduce more certainty, earlier in the application process, to the determination as to whether a potential transaction would be a higher-priced mortgage loan when consummated. The actual APR, however, would not be known to a certainty early in the application process, leaving some uncertainty as to whether a potential loan will be a higher-priced loan if it is actually originated. The APR disclosed within three days of application could change before closing for legitimate reasons such as changes in the interest rate or in the borrower's decision as to how many points to pay, if any. It is not expected, however, that an APR would change substantially in many cases for legitimate reasons.

Using two different trigger dates in Regulation C and Regulation Z § 226.35(a)—the rate lock date in the first and the application date in the second—could increase regulatory burden. Using the rate lock date in § 226.35(a), however, could increase uncertainty, relative to using the application date, as to whether a loan would be higher-priced when consummated. The Board believes the potentially somewhat higher regulatory burden from inconsistency may be justified by the increase in certainty.

Requests for Comment

The Board seeks data with which to evaluate the proposed approach to matching mortgage loans to Treasury securities and the proposal to select the appropriate Treasury security based on the application date. The Board also solicits suggestions for alternative approaches that would better meet the objectives of relative simplicity and reasonably accurate coverage.

VII. Proposed Rules for Higher-Priced Mortgage Loans—§ 226.35

A. Overview

This part discusses the new consumer protections the Board proposes to apply to ''higher-priced mortgage loans.'' A creditor would be prohibited from engaging in a pattern or practice of making higher-priced mortgage loans based on the collateral without regard to repayment ability. A creditor would also be prohibited from making an individual higher-priced mortgage loan without: Verifying the income and assets the creditor relied upon to make the loan; and establishing an escrow account for taxes and insurance. In addition, a higher-priced mortgage loan

could not have a prepayment penalty except under certain conditions.

The Board believes that the practices that would be prohibited, when conducted in connection with higher-priced mortgage loans, are unfair, deceptive, associated with abusive lending practices, and otherwise not in the interest of the borrower. *See* TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), and the discussion of this statute in part V above. Making higher-priced mortgage loans without adequately considering repayment ability, verifying income or assets, or establishing an escrow account for taxes and insurance significantly increases the risk that consumers will not be able to repay their loans. When consumers cannot repay their loans and must choose between losing their homes and refinancing in an effort to stay in their homes, they are more vulnerable to such abuses as loan flipping and equity stripping. Prepayment penalties in certain circumstances can exacerbate these injuries by making it more costly to exit unaffordable loans.

The Board has considered that some of the practices that would be prohibited may benefit some consumers in some circumstances. As discussed more fully below with respect to each prohibited practice, however, the Board believes that in connection with higher-priced mortgage loans these practices are likely to cause more injury to consumers than any benefit the practices may provide them. The Board has also considered that the proposed rules may reduce the access of some consumers in some circumstances to legitimate and beneficial credit arrangements, either directly as a result of a prohibition or indirectly because creditors may incur, and pass on, increased compliance and litigation costs. The Board believes the benefits of the proposal outweigh these costs.

The Board has also considered other, potentially less burdensome, approaches such as requiring more, or better, disclosures. For reasons discussed in part II.C., the Board believes that disclosures alone may not provide consumers in the subprime market adequate protection from unfair, deceptive, and abusive lending practices. The discussion below sets forth additional reasons why disclosures and other possible alternatives to the proposed prohibitions may not give adequate protection.

In addition to proposing new protections for consumers with higher-priced mortgage loans, the Board is also proposing to prohibit a creditor from structuring a closed-end mortgage loan as an open-end line of credit for the purpose of evading the restrictions on higher-priced mortgage loans, which do not apply to open-end lines of credit. This proposal is based on the authority of the Board under TILA Section 129(l)(2) to prohibit practices that would evade Board regulations adopted under authority of that statute. 15 U.S.C. 1639(l)(2).

B. Disregard of Consumers' Ability to Repay—§§ 226.34(a)(4) and 226.35(b)(1)

TILA Section 129(h), 15 U.S.C. 1639(h), and Regulation Z § 226.34(a)(4) currently prohibit a pattern or practice of extending HOEPA loans based on consumers' collateral without regard to their repayment ability. HOEPA loans are, however, a very small portion of the subprime market. The Board is proposing to extend the prohibition against a pattern or practice of lending based on consumers' collateral without regard to their repayment ability to higher-priced mortgage loans as defined in § 226.35(a). The prohibition in § 226.34(a)(4) would be revised somewhat, and this revised prohibition would be incorporated as proposed new § 226.35(b)(1).

Public Comment on Determining Ability To Repay

In the Board's June 14, 2007 hearing notice, the Board solicited comment on the following alternatives to ensure borrowers' repayment ability:

- Should lenders be required to underwrite all loans based on the fully-indexed rate and fully amortizing payments?
- Should there be a rebuttable presumption that a loan is unaffordable if the borrower's debt-to-income (DTI) ratio exceeds 50 percent?
- Are there specific consumer disclosures that would help address concerns about unaffordable loans?

Few commenters offered specific disclosure suggestions but many commenters and hearing witnesses addressed the first two questions. Most consumer and community groups who commented support a requirement to underwrite ARMs using the fully-indexed, fully-amortizing rate. Several recommended, however, that the Board require underwriting to the maximum rate possible or, at least, to a rate higher than the fully-indexed rate. These commenters are concerned that using the fully-indexed rate would not adequately assure repayment ability because indexes can increase.

All of the financial institutions and financial services trade groups who responded to the question agree that underwriting a loan based on its fully-indexed interest rate and fully-amortizing payment is generally prudent. With few exceptions, however, most of these commenters oppose codifying such a standard in a regulation, arguing that a regulation would be too rigid, constrain lenders from relying on their own experience and judgment, and make ARMs unavailable to many subprime borrowers. Several financial institutions and trade groups asked that any fully-indexed rate requirement the Board adopts be limited to ARMs with introductory fixed-rate periods of less than five years. They maintained that most borrowers having ARMs with longer fixed-rate periods refinance before the rate adjusts.

Consumer and community groups argue that a requirement to underwrite to the fully-indexed rate would not assure that loans would be affordable unless the Board also specified a maximum debt-to-income (DTI) ratio. Most groups stated that a maximum 50 percent DTI ratio would be an appropriate threshold to identify presumptively unaffordable loans. On the other hand, the vast majority of the financial institution and industry trade group commenters oppose adoption of a maximum DTI ratio. Some stated the DTI ratio is not one of the most important predictors of loan performance. Others noted the difficulties of clearly defining ''debt'' and ''income'' for purposes of such a rule, or of clearly defining mitigating factors such as high credit scores. Some identified categories of borrowers for whom high DTIs are not inappropriate, such as high-income borrowers; borrowers with substantial assets; and borrowers refinancing or consolidating loans with even higher payment burdens.

Discussion

Recent evidence of disregard for repayment ability. Subprime loans are expected to default at higher rates than prime loans because they generally are made to higher-risk borrowers. But the high frequency of so-called 2–28 and 3–27 ARMs in subprime originations in recent years—and the recent rapid and significant increase in serious delinquencies and foreclosures among such loans originated from 2005 to early 2007, including within several months of closing—have raised serious questions as to whether originators have paid adequate attention to repayment ability. Approximately three-quarters of securitized originations in subprime pools from 2004 to 2006 were of 2–28 or 3–27 ARMs, or ARMs with interest rates discounted for two or three years and fully-indexed afterwards. In a

typical case of a 2–28 discounted ARM, a $200,000 loan with a discounted rate of 7 percent for two years (compared to a fully-indexed rate of 11.5 percent) and a 10 percent maximum rate in the third year would start at a payment of $1,531 and jump to a payment of $1,939 in the third year, even if the index value did not increase. The rate would reach the fully-indexed rate in the fourth year (if the index value still did not change), and the payment would increase to $2,152.[49]

In recent years many subprime lenders did not consider adequately whether borrowers would be able to afford the higher payment, and appeared instead to assume that borrowers would be able to refinance notwithstanding their very limited equity. Originators extended some 2–28 ARMs from 2005 to early 2007 without having reason to believe the borrower would be able to afford the payment after reset. Originators may have assumed that these borrowers would refinance before reset, an assumption that proved unrealistic, at least under newly tightened lending standards, when house prices fell and the borrowers could not accumulate enough equity to refinance. In fact, some 2–28 ARMs originated in 2005 and 2006 appear to have been made to borrowers who could not afford even the initial payment. Over 10 percent of the 2–28 ARMs originated in 2005 appear to have become seriously delinquent before their first reset.[50] While some borrowers may have been able to make their payments—they stopped making payment because the values of their houses declined and they lost what little equity they had—others may not have been able to afford even their initial payments.

Potential reasons for unaffordable loans. There are several reasons why borrowers, especially in the subprime market, would accept loans they would not be able to repay. In some cases, less scrupulous originators may mislead borrowers into entering into unaffordable loans by understating the payment before closing and disclosing the true payment only at closing. At the closing table, many borrowers may not notice the disclosure of the payment or have time to consider it; or they may consider it but feel constrained to close the loan. This constraint may arise from a variety of circumstances. For example, the borrower may have signed agreements to purchase a new house and to sell the current house. Or the borrower may need to escape an overly burdensome payment on a current loan, or urgently need the cash that the loan will provide for a household emergency.

In the subprime market in particular, consumers may accept loans knowing they may have difficulty affording the payments because they do not have reason to believe a more affordable loan would be available to them. Possible sources of this behavior, including the limited transparency of prices, products, and broker incentives in the subprime market, are discussed in part II.C. Borrowers who do not expect any benefit from shopping further, which can be costly, make a reasoned decision not to shop and to accept the terms they believe are the best they can get.

Furthermore, borrowers' own assessment of their repayment ability may be influenced by their belief that a lender would not provide credit to a consumer who did not have the capacity to repay. Borrowers could reasonably infer from a lender's approval of their applications that the lender had appropriately determined that they would be able to repay their loans. Borrowers operating under this impression may not independently assess their repayment ability to the extent necessary to protect themselves from taking on obligations they cannot repay. Borrowers are likely unaware of market imperfections that may reduce lenders' incentives to fully assess repayment ability. *See* part II.C. In addition, lenders and brokers may sometimes encourage borrowers to be excessively optimistic about their ability to refinance should they be unable to sustain repayment. For example, they sometimes offer reassurances that interest rates will remain low and house prices will increase; borrowers may be swayed by such reassurances because they believe the sources are experts.

Injuries from unaffordable loans. When borrowers cannot afford to meet their payment obligations, they and their communities suffer significant injury. Such borrowers are forced to use up home equity or other assets to cover the costs of refinancing. If refinancing is not an option, then borrowers must make sacrifices to keep their homes. If they cannot keep their homes, then they must sell before they had planned or endure foreclosure and eviction; in either case they may owe the lender more than the house is worth. If a neighborhood has a concentration of unaffordable loans, then the entire neighborhood may endure a decline in homeowner equity. Moreover, if disregard for repayment ability contributes to a rise in delinquencies and foreclosures, as appears to have happened recently, then the credit tightening that may follow can injure all consumers who are potentially in the market for a mortgage loan.

Potential benefits. There does not appear to be any benefit to consumers from loans that are clearly unaffordable at origination or immediately thereafter. The Board recognizes, however, that some consumers may in some circumstances benefit from loans whose payments would increase significantly after an initial period of reduced payments. For example, some consumers may expect to be relocated by their employers and therefore intend to sell their homes before their payment would increase significantly. Moreover, a planned increase in the payment that would not be affordable at consumers' current incomes (as of consummation) may be affordable at the incomes consumers can document that they reasonably expect to earn when the payment increases. The proposal described below is intended to provide sufficient flexibility to creditors to ensure that credit would be available under such circumstances.

Consumers may also benefit from loans with payments that could increase after an initial period of reduced payments if they have a realistic chance of refinancing, before the payment burden increases substantially, into lower-rate loans that were more affordable on a longer-term basis. This benefit is, however, quite uncertain, and it is accompanied by substantial risk. Consumers would have to both improve their credit scores sufficiently and accumulate enough equity to qualify for lower-rate loans. Concerns about the affordability after reset of 2–28 and 3–27 ARMs originated from 2005 to early 2007 illustrate the hazards of counting on both developments occurring before payments become burdensome. Marketed as ''affordability products,'' these loans often were made with high loan-to-value ratios on the assumption that house prices would appreciate. In areas where house price appreciation slowed or prices declined outright, the assumption proved unreliable. Moreover, the Board is not aware of evidence on the proportion of such borrowers who were actually able to raise their credit scores enough to

[49] This example is taken from the federal agencies' proposed subprime illustrations. Proposed Illustrations of Consumer Information for Subprime Mortgage Lending, 72 FR 45495, 45497 n.2 & 45499, Aug. 14, 2007. The example assumes an initial index of 5.5 percent and a margin of 6 percent; assumes annual payment adjustments after the initial discount period; a 3 percent cap on the interest rate increase at the end of year 2; and a 2 percent annual payment adjustment cap on interest rate increases thereafter, with a lifetime payment adjustment cap of 6 percent (or a maximum rate of 13 percent).

[50] Figure calculated from First American LoanPerformance data.

qualify for lower-rate loans had they accumulated sufficient equity. In short, evidence from recent events is consistent with a conclusion that a widespread practice of making subprime loans with built-in payment shock after a relatively short period on the basis of assuming consumers will accumulate sufficient equity and improve their credit scores enough to refinance before the shock sets in can cause consumers more injury than benefit.

The Proposed Prohibition

HOEPA and § 226.34 prohibit a lender from engaging in a pattern or practice of extending credit subject to § 226.32 (HOEPA loans) 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. Under the proposal, the prohibition in § 226.34(a)(4) would be revised to clarify and strengthen it. The revised § 226.34(a)(4) would be incorporated into § 226.35(b) as one of the restrictions that apply to higher-priced mortgage loans. Higher-priced mortgage loans would be defined in § 226.35(a) as explained above.

As proposed, Regulation Z would prohibit a lender from engaging in a pattern or practice of making higher-priced mortgage loans based on the value of consumers' collateral without regard to consumers' repayment ability as of consummation, including consumers' current and reasonably expected income, current and reasonably expected obligations, employment, and assets other than the collateral. Each of the elements of this proposed standard is discussed below.

Collateral-based lending. The proposal would prohibit a pattern or practice of collateral-based lending with higher-priced mortgage loans. The Board recognizes that this proposal may reduce the availability of credit for consumers whose current and expected income and non-collateral assets are not sufficient to demonstrate repayment ability. For example, unemployed borrowers with limited assets apart from their homes may have more difficulty obtaining mortgage credit under this proposal if their combined risk factors are high enough that the APR of their potential loan would exceed the proposed threshold in § 226.35(a).

''Pattern or practice.'' The Board is not proposing to prohibit making an individual loan without regard to repayment ability, either for HOEPA loans or for higher-priced mortgage loans. Instead, the Board is proposing to retain the pattern or practice element in the prohibition, and to include that element in the proposed new prohibition for higher-priced mortgage loans. The ''pattern or practice'' element of the prohibition is intended to balance potential costs and benefits of the rule. Creating civil liability for an originator that fails to assess repayment ability on any individual loan could inadvertently cause an unwarranted reduction in the availability of mortgage credit to consumers. The ''pattern or practice'' element is intended to reduce that risk while helping prevent originators from making unaffordable loans on a scale that could cause consumers substantial injury.

Whether a creditor had engaged in the prohibited pattern or practice would depend on the totality of the circumstances in the particular case, as explained in an existing comment to § 226.34(a)(4). The comment further indicates that while a pattern or practice is not established by isolated, random, or accidental acts, it can be established without the use of a statistical process. It also notes that a creditor might act under a lending policy (whether written or unwritten) and that action alone could establish a pattern or practice of making loans in violation of the prohibition.

The Board is not proposing to adopt a quantitative standard for determining the existence of a pattern or practice. Nor does it appear feasible for the Board to give examples, as the inquiry depends on the totality of the circumstances. Comment is sought, however, on whether further guidance would be appropriate and specific suggestions are solicited.

''Current and expected income.'' The statute and regulation both prohibit a creditor from disregarding a consumer's repayment ability, including current and expected income. The Board proposes to retain the references to expected and current income, and to clarify that expectations of income must be reasonable. The Board believes consumers may benefit if a creditor is permitted to take into account reasonably expected increases in income. For example, a consumer seeking a professional degree or certificate may, depending on the job market and other relevant circumstances, reasonably anticipate an increase in income after obtaining the degree or certificate. Under the proposal, a creditor could consider such an increase. For consumers who do not have a current income and cannot demonstrate a reasonable expectation of income, creditors may consider assets other than the collateral.

Other proposed clarifications. Several other revisions are proposed for clarity. The phrase ''as of consummation'' would be added to make clear that the prohibition is based on the facts and circumstances that existed as of consummation. Under proposed comment 34(a)(4)–2, events after consummation, such as an unusually high default rate, may be relevant to determining whether a creditor has violated § 226.34(a)(4), but events after consummation do not, by themselves, establish a violation. The comment would provide the following example: a violation is not established if borrowers default after consummation because of serious illness or job loss.

In addition, to clarify the basis for determining repayment ability the regulation and existing comments would be revised, and new comments would be added. First, comment 34(a)(4)–1 (renumbered as 34(a)(4)–3) would be revised to clarify the regulation's reference to employment as a factor in determining repayment ability. The comment would indicate that in some circumstances it may be appropriate or necessary to take into account expected changes in employment. For example, depending on all of the facts and circumstances, it may be reasonable to assume that students obtaining professional degrees or certificates will obtain employment upon receiving the degree or certificate.

Second, the regulation would be revised to refer not just to current obligations but also to expected obligations. This would make the reference to obligations parallel to the statute and regulation's references to current and expected income. Proposed comment 34(a)(4)(i)(A)–2 would clarify that, where two different creditors are extending loans simultaneously to the same consumer, one a first-lien loan and the other a subordinate-lien loan, each creditor would generally be expected to verify the obligation the consumer is undertaking with the other creditor. A pattern or practice of failing to do so would create a presumption of a violation.

Third, the revised regulation would make clear that creditors may rely on assets other than the collateral to determine repayment ability. An existing comment would be revised to give these examples: A savings accounts or investments that can be used by the consumer. The Board believes it is appropriate for lenders to consider non-collateral assets such as these in determining repayment ability, and for consumers to be free to substitute assets for income in meeting their obligations.

Fourth, minor revisions would be made to § 226.34(a)(4) solely for clarity. The term ''consumer'' in the regulation would be put in the plural, ''consumers,'' to reflect that the prohibition concerns a pattern or practice. The phrase ''based on consumers' collateral'' would be revised to read ''based on the value of consumers' collateral.'' No change in meaning is intended.

Proposed Presumptions

Section 226.34(a)(4) contains a provision creating a rebuttable presumption of a violation where a lender engages in a pattern or practice of failing to verify and document repayment ability. The proposed regulation would retain this presumption, which would be incorporated in proposed § 226.35(b)(1). The Board is also proposing to add new, rebuttable presumptions to § 226.34(a)(4) and, by incorporation, § 226.35(b)(1). These would be presumptions of a violation for engaging in a pattern or practice of failing to consider: consumers' ability to pay the loan based on the interest rate specified in the regulation (§ 226.34(a)(4)(i)(B)); consumers' ability to make fully-amortizing loan payments that include expected property taxes and homeowners insurance (§ 226.34(a)(4)(i)(C)); the ratio of borrowers' total debt obligations to income as of consummation (§ 226.34(a)(4)(i)(D)); and borrowers' residual income (§ 226.34(a)(4)(i)(E)).

A new comment 34(a)(4)(i)–1 would clarify that the presumption for failing to verify income as well as the proposed new presumptions would be rebuttable by the lender with evidence that the lender did not disregard repayment ability. The comment would also clarify that the presumptions are not exhaustive. That is, a creditor may violate § 226.34(a)(4) (or § 226.35(b)(1)) by patterns or practices other than those specified in paragraph 34(a)(4)(i).

Each of the proposed presumptions is discussed in turn below. Comment is sought generally on the appropriateness of the proposed presumptions, and on whether additional presumptions should be adopted.

Failure to verify. Section 226.34(a)(4) contains a provision creating a rebuttable presumption of a violation where a lender engages in a pattern or practice of failing to verify and document repayment ability. The proposed regulation would retain this presumption, though it would be placed, along with other proposed new presumptions, in new sub-paragraph (i) of § 226.34(a)(4). It would also be revised to refer explicitly to the aspects of repayment ability identified in § 226.34(a)(4), namely, borrower's current and reasonably expected income and assets, current and reasonably expected obligations, and employment. It would also refer to the verification requirements stated in § 226.35(b)(2)(i). Under § 226.35(b)(2), a lender would be required to verify amounts the lender relies on by the consumer's Internal Revenue Service Form W–2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income and assets. *See* part VII.C. A new comment would clarify that a pattern or practice of failing to verify obligations would also trigger a presumption of a violation. It would indicate, however, that a credit report generally may be used to verify obligations.

Ability to make fully-indexed, fully-amortizing payments. Variable rate mortgages with discounted initial rates have become common in the subprime market. In a typical example, a loan would have an index and margin at consummation of 11.5 percent but a discounted initial rate for the first two years of 7 percent. Determining repayment ability on the basis of the initial rate would not give a realistic picture of the borrower's ability to afford the loan once the rate began adjusting according to the agreed index and margin.[51] The Board is proposing in § 226.34(a)(4)(i)(B) that a pattern or practice of failing to consider a borrower's repayment ability at the fully-indexed rate would create a presumption of a violation of § 226.34(a)(4) (or § 226.35(b)(1)).

Section 226.34(a)(4)(i)(B) would also address the case of a step-rate loan, a loan in which specific interest rate changes are agreed to in advance. For example, the parties could agree that the interest rate on the loan would be 5 percent for two years, 6 percent for two years, and 7 percent thereafter. The regulation would provide that, for such loans, a failure to consider the borrower's repayment ability at the highest interest rate possible within the first seven years of the loan's term (seven percent in the example) would create a presumption of a violation. The Board seeks comment on whether a shorter period, such as five years, would be appropriate.

The Board also seeks comment on whether this presumption should be modified to accommodate loans with balloon payments and, if so, how it should be modified.

Borrower debt-to-income ratio and residual income. The proposed presumptions of a violation for failure to consider the debt-to-income ratio (§ 226.34(a)(4)(i)(D)) or residual income ((§ 226.34(a)(4)(i)(E)) reflect the fact that this information generally is part of a responsible determination of repayment ability. Comment 34(a)(4)(i)(D)–1 would clarify, however, that the Board is not proposing a specific debt-to-income ratio that would create a presumption of a violation; nor is the Board proposing a specific ratio that would be a safe harbor. Similarly, comment 34(a)(4)(i)(E)–1 would indicate that the regulation does not require a specific level of residual income.

The Board is concerned that making a specific debt-to-income ratio or residual income level either a presumptive violation or a safe harbor could limit credit availability without providing adequate off-setting benefits. These are but two of many factors that determine repayment ability. For example, depending on the circumstances, the repayment risk implied by a high debt-to-income ratio could be offset by other factors that reduce the risk, such as a high credit score and a substantial down payment. The Board is reluctant to adopt a quantitative standard for one or two underwriting factors when repayment ability depends on the totality of many inter-relating factors.

It is possible, however, that adopting a quantitative standard for the debt-to-income ratio or other underwriting factors would provide at least some benefit to creditors and, by extension, consumers, by providing bright lines. The Board seeks comment on whether it should adopt a presumption of a violation, or a safe harbor, at a 50 percent debt-to-income ratio, or at a lower or higher ratio. What exceptions would be necessary for borrowers with high incomes or substantial assets, or for other cases? Comment is also sought on whether the Board should in addition, or instead, adopt quantitative standards for presumptive violations, or safe harbors, based on other underwriting factors.

Property taxes and insurance. Section 226.34(a)(4)(i)(C) would create a separate presumption of a violation of § 226.34(a)(4) (or § 226.35(b)(1)) for a pattern or practice of failing to consider the borrower's repayment ability based on a fully-amortizing payment that includes expected property taxes,

[51] As discussed in part IV above, concerns about underwriting practices for products with introductory rates or payments led the Board and the other federal supervisory agencies to issue guidance advising institutions to qualify borrowers using the fully-indexed rate and fully amortizing payments.

homeowners insurance, and other specified housing expenses. This is intended to address concerns that some creditors would determine a borrower's ability to repay a nontraditional loan that offered an option to defer principal or interest for several years on the basis of a payment that was non-amortizing (interest only) or negatively amortizing (less than interest). Negative amortization also can arise on variable-rate transactions with annual payment caps. The proposed presumption would encourage lenders to consider the fully-amortizing payment, as the Subprime Guidance advises lenders to do. *See* part V. The fully-amortizing payment would be based on the term of the loan. For example, the amortizing payment for a 2–28 ARM would be calculated based on a 30-year amortization schedule.

Proposed Time Horizon

The Board recognizes that it may not be reasonable, or to consumers' benefit, to hold creditors responsible for assuring repayment ability for the life of a loan. Most mortgage loans have terms of thirty years but prepay long before that. The Board seeks to ensure that consumers retain the ability to exchange lower initial payments for higher payments later, or for a balloon payment at the end of the loan. Accordingly, a safe harbor for creditors may be appropriate so long as it assures payments will be affordable for a reasonable time. Proposed § 226.34(a)(4)(ii) would provide that a creditor does not violate § 226.34(a)(4) if the creditor has a reasonable basis to believe that consumers will be able to make loan payments for at least seven years, considering each of the factors identified in § 226.34(a)(4)(i) (such as the fully-indexed rate and the fully-amortizing payment schedule) and any other factors relevant to determining repayment ability.

This proposal is not intended to preclude creditors from offering loans with substantial payment increases before seven years. If such loans fell outside of the safe harbor, they could nonetheless be justified in appropriate circumstances. For example, a consumer with a documented intent to sell the home within three years may reasonably choose a loan with a substantial payment increase in the third year. The Board seeks comment, however, on whether specifying a shorter time horizon, such as five years, would be appropriate.

General Request for Comment

In addition to the specific requests for comment stated above, the Board seeks comment on whether proposed §§ 226.34(a)(4) and 226.35(b)(1) would ensure that creditors adequately consider repayment ability without unduly constraining credit availability. The Board seeks data and information that could help the Board evaluate the costs and benefits of the proposal as it would affect the subprime market and any portion of the alt-A market to which the proposal may apply.

C. Verification of Income and Assets Relied on—§ 226.35(b)(2)

Proposed § 226.35(b)(2) would prohibit creditors in a transaction subject to § 226.35(a) from relying on amounts of assets or income, including expected income, in extending credit unless the creditor verifies such amounts. Creditors who fail to verify income or assets before extending credit are given a safe harbor if they can show that the amounts of the consumer's income or assets relied on were not materially greater than what the creditor could have documented at consummation.

Public Comment on Stated Income Lending

In the hearing notice, the Board solicited comment on the following questions:

- Whether stated income or low-documentation loans should be prohibited for certain loans, such as loans to subprime borrowers?
- Whether stated income or low-documentation loans should be prohibited for higher-risk loans, for example, for loans with high loan-to-value ratios?
- How a restriction on stated income or low-documentation loans would affect consumers and the type and terms of credit offered?
- Whether lenders should be required to disclose to the consumer that a stated income loan is being offered and allow the consumer the option to document income?

Consumer and community groups, individuals, and political officials, and some financial institutions and groups, favored greater restrictions on stated income loans for two reasons. First, some borrowers who could easily document their income have been harmed by receiving stated income loans that cost them more than a full documentation loan. According to commenters, these borrowers did not realize that they could have received a less costly loan by documenting their incomes. Second, other borrowers have been harmed when originators inflated their incomes—often without consumers' knowledge—to assure the originator would be able to make the loan or to enable the originator to make a larger loan, which might have higher payments that were less affordable to the consumer. To address these concerns, these commenters favored requiring creditors to obtain some documentation to support a consumer's statement of income or assets. Some suggested that documentation be required only for subprime loans, while others suggested it be required for all loans.

In contrast, most financial institution and financial services trade group commenters opposed prohibiting stated income loans. These commenters argued that financial institutions should retain flexibility to accommodate borrowers who may have difficulty fully documenting their income, or whose credit risk profile is strong enough that their income is not used as an underwriting factor. Some of these commenters did, however, support the banking agencies' use of guidance, such as the Subprime Statement, to address any risks of stated income loans. One major mortgage lender supported limiting stated income lending in subprime loans by a new regulation, if the regulation allowed for mitigating circumstances.

Discussion

Until recently, large and increasing numbers of home-secured loans in the subprime market were underwritten without fully verifying the borrower's income and assets.[52] The share of ''low doc'' and ''no doc'' loan originations in the securitized subprime market rose from 20 percent in 2000, to 30 percent in 2004, to 40 percent in 2006.[53] Low and no documentation loans are more prevalent in the Alt-A market, where originations of such loans in securitized pools rose from about 60 percent in 2000–2004 to 80 percent in 2006. Not all low doc or no doc loans are stated income loans (because in some cases originators did not rely on income or assets as the source of repayment), but many are.

Lending based on unverified, or minimally verified, incomes or assets can be appropriate for consumers whose risk profiles justify the potential increased risk and who might otherwise have to incur a significant cost to document their incomes or assets. The practice, however, increases the risk

[52] *See* U.S. Gov't Accountability Office, GAO–08–78R, *Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments* 5 (2007); Fannie Mae, Weekly *Economic Commentary* (Mar. 26, 2007).

[53] Figures calculated from First American Loan Performance data.

that credit is extended on the basis of inflated incomes and assets, which, in turn, can injure not just the particular borrowers whose incomes or assets were inflated but their neighbors, as well. The practice also presents an opportunity for originators to mislead consumers who could easily document their incomes and assets into paying a premium for a stated income or stated asset loan. These concerns are addressed in turn below.

Risk of inflated incomes and assets. There is anecdotal evidence that the incomes used in stated income loans were often inflated.[54] There is also evidence in the form of a higher rate of default for low doc and no doc loans (many of which are stated income loans) than for full documentation loans, and in the increase in the rate of default for low/no doc loans originated when underwriting standards were declining.[55]

Stated income lending programs give originators incentives as well as opportunities to inflate an applicant's income or assets, or to encourage applicants to do so. Compensating the originator based on loan size and origination volume, common practices, may give the originator incentives to maximize loan size and origination volume at the expense of loan quality. Inflating income or assets can increase both loan size and origination volume, because it can cause a creditor to accept an application that would otherwise have been rejected or met with an offer of a smaller loan.

The nature of the application process makes it possible that an applicant would not learn that the originator had inflated the applicant's income or assets. In many cases, applicants may not even know that they are obtaining stated income loans. They may have given the originator documents verifying their income and assets that the originator kept from the loan file so that the loan could be classified as ''stated income, stated assets.'' If an applicant has applied knowingly for a stated income or stated assets loan, the originator may fill out the financial statement on the standard application form based on information the applicant provides orally. The applicant may not review the form closely enough to detect errors in the stated income or assets, especially if seeing the form for the first time at the closing table. A consumer who detects errors at the closing table may not realize their importance or may face constraints that make it particularly difficult to walk away from the table without the loan.

While some originators may inflate income without consumers' knowledge, other originators may tacitly encourage applicants to knowingly state inflated incomes and assets by making it clear that their actual incomes and assets are not high enough to qualify them for the loans they seek. Such originators may reassure applicants that this is a benign and common practice. In addition, applicants may inflate their incomes and assets on their own initiative in circumstances where the originator does not have reason to know.

Injuries from inflated income and assets. The injuries to consumers from extending credit based on inflated incomes and assets are apparent. Borrowers whose loans are underwritten based on inflated income may receive larger loans with payments larger than they can comfortably afford and, therefore, face a higher risk of default as well as a higher risk of serious delinquency leading to foreclosure or distress sale. These risks are particularly pronounced for borrowers in the subprime market because their financial situations often are more precarious. The injuries caused by income inflation are not limited either to the particular borrowers whose incomes were inflated by the originator, nor to particular borrowers who inflated their incomes on their own. The practice can injure many other consumers, too. Inflating applicant incomes raises the risk of distress sales and foreclosures, concentrations of which can depress an entire community. Moreover, a widespread practice of inflating applicant incomes in an area with rapid house price appreciation—the kind of area where the practice may be most likely to arise—may fuel this appreciation and contribute to a ''bubble.''

Undisclosed premiums. Stated income lending also potentially injures consumers by leading them to pay more for their loans than they otherwise would. There is generally a premium for a stated income loan. An originator may not have sufficient incentive to disclose the premium on its own initiative because collecting and reviewing documents could slow down the origination process, reduce the number of loans an originator produces in a period, and, therefore, reduce the originator's compensation for the period. The risk that a consumer would not be aware of the premium may be particularly acute where products are complex, as is often true in the subprime market and was, at least until recently, true in the alt-A market due to the rapid growth of interest-only loans and option ARMs. Thus, consumers who can document income with little effort may choose not to because they are unaware of the cost of a stated income loan. Such consumers are effectively deprived of an opportunity to shop for a potentially lower-rate loan requiring full documentation.

The Board recognizes that stated income lending in the subprime market may have potential benefits. It may speed credit access by several days for consumers who need credit on an emergency basis. It may save some consumers from expending significant effort to document their income, and it may provide access to credit for consumers who otherwise would not have access because they actually cannot document their income, for whatever reason. For the reasons discussed above, however, the Board believes that, within the subprime market, where risks to consumers are already elevated, the potential benefits to consumers of stated income/stated asset lending may be outweighed by the potential injury to consumers and competition. Stated-income lending is a significant part of the neighboring alt-A market, but, there too, it can raise concerns. Until the recent tightening of underwriting standards in the alt-A market, stated-income lending was increasingly layered on top of other risks, such as loan terms that permit the borrower to defer payment of interest or principal.

The Board's Proposal

To address the injuries to consumers from stated income loans in the higher-priced market, the Board proposes to require creditors to verify the income and assets *they rely on* with third-party documents that provide reasonably reliable evidence such as W–2 forms, tax returns, payroll receipts, or financial institution records. The rule is intended to be flexible and appropriately balance costs with benefits.

The benefits of the proposal would appear to be significant. The rule should make it more difficult for any party to inflate incomes or assets on higher-priced mortgage loans and, therefore,

[54] *See* Mortgage Asset Research Inst., Inc., *Eighth Periodic Mortgage Fraud Case Report to the Mortgage Bankers Association* (2006) (reporting that 90 of 100 stated income loans sampled used inflated income when compared to tax return data); Fitch Ratings, *Drivers of 2006 Subprime Vintage Performance (Fitch 2006 Subprime Performance)* (November 13, 2007) (reporting that stated income loans with high combined loan to value ratios appear to have become vehicles for fraud).

[55] Michelle A. Danis and Anthony Pennington-Cross, *The Delinquency of Subprime Mortgages*, Journal of Economics and Business (forthcoming 2007); *see also Fitch 2006 Subprime Performance* (stating that lack of income verification, as opposed to lack of employment or down payment verification, caused 2006 low documentation loans delinquencies to be higher than earlier vintages' low documentation loans).

reduce the frequency of the practice and the injuries to consumers the practice can cause. The rule also should eliminate the risk that consumers with higher-priced mortgage loans who could document income would unknowingly pay more for a loan that did not require documentation.

The proposal could have costs as well. In general, the time from application to closing could be longer if an applicant were required to produce, and the creditor required to review, third party documents verifying income. Also, consumers who did not have documents verifying their income readily at hand would face the inconvenience of obtaining such documents. Another cost could be reduced access to credit for consumers who would have difficulty documenting their income. As explained further below, the Board believes the regulation is sufficiently flexible to keep these costs to reasonable levels relative to the expected benefits of the proposed rule.

Five elements of the proposal are intended to reduce the costs to consumers and creditors that income verification may entail. First, the proposed rule requires that only the income or assets the creditor relies upon in approving the extension of credit be verified. For example, if a creditor does not rely on a part of the consumer's income, such as an annual bonus, in approving the extension of credit, the creditor would not need to verify the consumer's bonus.[56]

Second, the proposed rule specifically authorizes a creditor to rely on W–2 forms, tax returns, payroll receipts, and financial institution records. These kinds of documents generally have proven to be reliable sources of information about borrowers' income and assets. Moreover, most consumers can, or should be able to, produce one of these kinds of documents with little difficulty. Thus, the proposed safe harbor for relying on one of these kinds of documents should protect consumers while minimizing costs.

Third, creditors may use any other third-party documents that provide reasonably reliable evidence of the borrower's income and assets. Examples of other third-party documents that provide reasonably reliable evidence of the borrower's income include check-cashing receipts or a written statement from the consumer's employer. *See* proposed comment 35(b)(2)–4. These are but examples, and a creditor may rely on third-party documents of any kind so long as they are reasonably reliable. The one kind of document that is categorically excluded is a statement only from the consumer.

Fourth, the proposal is not intended to limit creditors' ability to adjust their underwriting standards for consumers who for legitimate reasons have difficulty documenting income, such as self-employed borrowers, or employed borrowers with irregular income.[57] For example, the rule would not dictate that a creditor must have at least two year's tax returns to approve an extension of credit to a self-employed borrower. As another example, if a creditor relied on a statement by an employed applicant that the applicant was likely to receive an annual bonus from the employer, the creditor could verify the statement with third-party documents showing a consumer's past annual bonuses. *See* proposed comment 35(b)(4)(i)–1. The same would hold for credit extended to employees who work on commission.

Fifth, creditors who have extended credit to a consumer and wish to extend new credit to the same consumer need not re-collect documents that the creditor previously collected from the consumer if the documents would not have changed since they were initially verified. *See* proposed comment 35(b)(2)(i)–4. For example, if the creditor has collected the consumer's 2006 tax return for a loan in May 2007, and the creditor makes another loan to that consumer in August 2007, the creditor may rely on the 2006 tax return.

Proposed safe harbor. The proposed rule would contain a safe harbor for creditors who fail to verify income before extending credit if the amounts of income or assets relied on were not materially greater than the creditor could have verified when the extension of credit was consummated. *See* proposed § 226.35(b)(2)(ii) and comment 35(b)(2)(ii)–1. The proposed safe harbor would cover cases where the creditor's failure to verify income would not have altered the decision to extend credit to the consumer or the terms of the credit.

Requests for Comment

The Board seeks comment on whether, and in what specific circumstance, the proposed rule would reduce access to credit for certain borrowers, such as the self-employed, who may have difficulty documenting income and assets. The Board also requests comment on whether the rule could be made more flexible without undermining consumer protection. Comment on these questions is solicited both with respect to the subprime market and any part of the alt-A market that the proposed definition of ''higher-priced mortgage loan'' would tend to cover. Comment is also sought on the appropriateness of the proposed safe harbor, and on whether other safe harbors would be appropriate.

Potential alternatives. The Board believes the proposed rule would provide consumers a significant new protection against lending based on income or asset inflation. It is also expected that creditors, regulators, and courts would find it relatively easy to determine compliance with the proposed rule. The Board recognizes, however, that the rule is broad in that it imposes a blanket requirement on all creditors to verify, for every higher-priced mortgage loan they originate, the income and assets they rely on, without consideration of the extent to which the risks of inflating income or assets may vary from case to case. This rule could increase costs for creditors as well as consumers. The rule is also broad in another respect: It imposes a blanket verification requirement on creditors even though consumers, themselves, may inflate their stated incomes without the creditor's knowledge. Such consumers might in some instances seek to enforce the proposed rule through civil actions.

For these reasons, the Board seeks suggestions of narrower alternatives that would impose fewer costs on creditors and consumers while providing sufficient protection to consumers who may be injured, directly or indirectly, by stated income lending. For example, should the Board, instead of adopting the proposed rule, prohibit creditors and mortgage brokers from inflating incomes, influencing consumers to inflate incomes, or extending credit while having reason to believe that a consumer inflated income or was influenced to inflate income? Would a rule attempting to distinguish cases where creditors or brokers were not complicit in applicants' inflating incomes be cost-effective and practicable? If such a rule were adopted, should it provide a safe harbor for verifying income?

Subordinate-lien loans. The Board's proposal covers both first-lien and subordinate-lien loans, but the Board requests comment on whether the proposed rule should make an exception for all subordinate-lien loans, or for subordinate-lien loans in amounts

[56] Creditors would, however, still be prohibited from engaging in a pattern or practice of extending higher-priced mortgage loans to consumers based on the collateral without regard to repayment ability. *See* proposed § 226.35(b)(1). Consequently, creditors would not be able to evade the proposed income verification rule by consistently declining to consider income or assets.

[57] For depository institutions and their affiliates, safety and soundness considerations would continue to govern underwriting, as always.

less than a specified dollar amount, or less than a specified percentage of the home's value. Requiring income and asset verification for subordinate-lien loans could in some cases increase costs without providing meaningful protection to consumers. For example, if a consumer has a record of making timely payments on a first-lien loan, then verifying income or assets for a small subordinate-lien loan—assuming the creditor relied on income or assets to make the credit decision—may not provide sufficient additional information about the borrower's ability to repay the debt to justify the cost of verification. Thus, the Board seeks suggestions for potential exemptions for subordinate-lien loans that would not undermine consumer protection.

D. Prepayment Penalties—§ 226.32(d)(6) and (7); § 226.35(b)(3)

Pursuant to TILA Section 129(c), a HOEPA-covered loan may not provide for a prepayment penalty unless: the borrower's debt-to-income (DTI) ratio at consummation does not exceed 50 percent (and debt and income are verified); prepayment is not made using funds from a refinancing by the same creditor or its affiliate; the penalty term does not exceed five years from loan consummation; and the penalty is not prohibited under other applicable law. 15 U.S.C. 1639(c); *see also* 12 CFR 226.32(d)(6) and (7). The Board proposes to apply these restrictions to higher-priced mortgage loans. In addition, the Board proposes to require that the period during which a creditor may impose a prepayment penalty expire at least sixty days before the first date, if any, on which the periodic payment amount may increase under the terms of the loan.

Public Comments on Prepayment Penalties

In connection with its June 14, 2007 HOEPA hearing, the Board requested public comment on the following questions:

- Should prepayment penalties be restricted? For example, should prepayment penalties that extend beyond the first adjustment period on an ARM be prohibited?
- Would enhanced disclosure of prepayment penalties help address concerns about abuses?
- How would a prohibition or restriction on prepayment penalties affect consumers and the type and terms of credit offered?

Consumer and community groups generally commented that prepayment penalties are linked to higher loan costs for some borrowers. Many brokers and loan officers have at least some discretion to decide what interest rate to offer borrowers. In general, the higher the rate, the greater the compensation the lender pays the originator. Because the lender seeks to recover this compensation from the borrower, the lender prefers loans with prepayment payment penalties in case the borrower refinances the loan. Consumer and community group commenters stated that consumers shopping for home loans do not consider back-end costs such as prepayment penalties but rather focus on monthly payments or ''teaser'' interest rates on ARMs. In addition, they maintained that prepayment penalties discourage borrowers from refinancing unaffordable loans or cause them to lose home equity when the penalty amount is included in the principal amount of a refinance loan.

Accordingly, most consumer and community groups recommended that the Board ban prepayment penalties on subprime home loans, a recommendation also made by state and local government officials and a trade group representing community development financial institutions. Consumer and community groups suggested that, at a minimum, if the Board permits prepayment penalties, it should require prepayment penalties for fixed-rate loans to expire two years after loan origination and prepayment penalties on subprime hybrid ARMs to terminate between sixty days and six months prior to the first rate adjustment on the loan. These groups stated that, although disclosures could be improved, doing so would not solve the problems associated with prepayment penalties in the subprime market.

Most financial institutions and financial services trade groups recommended that the Board concentrate on improving disclosures and limit any regulation to requiring that the penalty term on a subprime hybrid ARM end before the first rate adjustment. A majority of these commenters recommended that borrowers be allowed to refinance without penalty starting sixty days prior the first reset; a few commenters recommended thirty days. These commenters stated that additional restrictions on prepayment penalties would reduce the amount of credit lenders and investors make available in the affected market. With respect to fixed-rate loans, some financial institutions and industry trade groups stated that a three-year limit on the term of a prepayment penalty would be appropriate. Some credit union trade groups recommended a maximum term, such as one or two years, for a prepayment penalty, including a penalty on a fixed-rate loan.

Discussion

Prepayment risk measures the possibility that a loan will be repaid before the end of the loan term.[58] Because a prepayment results in payment of the principal ahead of schedule, the lender (or secondary-market investor) must reinvest the funds at the new market rate, which may be lower than the old rate, particularly in the case of a refinancing. A lender also may incur certain fixed costs, such as payments to a mortgage broker, that the lender seeks to recover even if the loan is repaid early. Lenders generally account for the risk of prepayment in setting the interest rate on the loan, and usually in the subprime market (but only occasionally in the prime market) also account for the risk by including a prepayment penalty clause in the loan agreement.

In principle, a lender may offer a consumer a choice between a loan with a prepayment penalty and a loan that does not have a penalty but has a higher interest rate. Consumers in the subprime market who understood the potential trade-off between the interest rate and prepayment penalty might be willing to accept a contract with a prepayment penalty in exchange for a lower interest rate. For example, they may expect that they will refinance their loans after taking some time to improve their credit scores enough to qualify for a lower rate. Such consumers may be willing to accept a penalty with a term roughly equivalent to the time they expect it will take them to improve their scores. Accordingly, prepayment penalties may benefit individual borrowers in the subprime market who in certain circumstances would voluntarily choose them.

Prepayment penalties may also benefit borrowers in the subprime market overall. Investors may find prepayment patterns more difficult to predict for subprime loans than for prime loans because prepayment of subprime loans depends not only on interest rate changes (as does prepayment of prime loans) but also on changes to borrowers' credit profiles that affect their chances of qualifying for a lower-rate loan. To the extent that penalties make the cash flow from investments backed by subprime mortgage more predictable, the secondary market may become more

[58] Robert B. Avery, Glenn B. Canner & Robert E. Cook, *New Data Reported under HMDA and Its Application in Fair Lending Enforcement,* 2005 Fed. Reserve Bulletin 344, 368.

liquid. A more liquid secondary market may benefit borrowers by lowering interest rates and increasing credit availability.

Prepayment penalties, however, also impose substantial costs on borrowers that may not be clear to them. These penalties can prevent borrowers who cannot afford to pay the penalty, either in cash or from home equity, from exiting unaffordable or high-cost loans. Moreover, borrowers who refinance and pay a penalty decrease their home equity and increase their loan balance if they finance the penalty into the new loan—as is likely if they are refinancing because of financial distress. The loss of home equity and the payment of interest on the financed penalty amount are particularly concerning if the refinance loan represents a loan ''flipping'' abuse.

The injuries prepayment penalties may cause consumers are particularly concerning because of serious questions as to whether borrowers knowingly accept the risk of such injuries. Current disclosures of prepayment penalties, including the disclosure of penalties in Regulation Z § 226.18(k), do not appear adequate to ensure transparency. Moreover, a Federal Trade Commission report concluded, based on consumer testing, that even an improved disclosure of the prepayment penalty left a substantial portion of the prime and subprime consumers interviewed without a basic understanding of the penalty.[59] It is questionable whether consumers can accurately factor a contingent cost such as a prepayment penalty into the price of a loan; unlike the interest rate and points, a prepayment penalty is not included in the APR.

The lack of transparency is particularly troubling when originators have incentives to impose prepayment penalty clauses on consumers without giving them a genuine choice. Individual originators may be able to earn larger commissions or yield spread premiums on subprime loans by securing loan agreements with penalties, which increase a lender's certainty of recouping from the consumer its payment to the originator. Originators may seek to impose prepayment penalty clauses on consumers simply to increase their own compensation. This risk appears particularly high in the subprime market, where most loans have had prepayment penalties and borrowers may not have had a realistic opportunity to negotiate for a loan without a penalty.

The Board plans to use consumer testing to improve the disclosure of prepayment penalties as part of its ongoing review of closed-end TILA rules, but the Board recognizes that disclosure has its limits. The prepayment penalty may be a term that highlights those limits. It is complicated for borrowers to process and of secondary importance to them compared to other loan terms. Accordingly, the Board is proposing to restrict prepayment penalties on higher-priced mortgage loans.

The Board's Proposal—In General

The Board proposes to apply HOEPA's prepayment penalty restrictions to a broader segment of the market, higher-priced mortgage loans, and to add a new restriction for mortgages whose payments may increase, such as ARMs. A HOEPA—covered loan may not provide for a prepayment penalty unless: the borrower's DTI ratio at consummation does not exceed 50 percent (and debt and income are verified); prepayment is not made using funds from a refinancing by the same creditor or its affiliate; the penalty term does not exceed five years from loan consummation; and the penalty is not prohibited under other applicable law. 15 U.S.C. 1639(c); § 226.32(d)(6) and (7). The Board proposes to apply these restrictions to higher-priced mortgage loans. In addition, the Board proposes to require that the period during which a creditor may impose a prepayment penalty expire at least sixty days before the first date, if any, on which the periodic payment amount may increase under the terms of the loan.[60]

The proposal is intended to prohibit prepayment penalties in cases where they may pose the greatest risk of injury to consumers. The 50 percent DTI cap, while not a perfect measure of affordability, may tend to reduce the likelihood that an unaffordable loan will have a prepayment penalty, which would hinder a consumer's ability to exit the loan by refinancing the loan or selling the house. The same-creditor restriction may reduce the likelihood that a creditor could ''pack'' a prepayment penalty into a loan as part of a strategy to strip the borrower's equity by flipping the loan in a short time. The five-year restriction would prevent creditors from ''trapping'' consumers in a loan for an exceedingly long period. The mandatory expiration of the penalty before a possible payment increase would help prevent consumers who had been enticed by a discounted initial payment from being trapped when the payment increased. Thus, the proposal would prohibit prepayment penalties in circumstances indicating a higher risk of injury.

The proposal is also intended to preserve the potential benefits of penalties to consumers in cases where the penalties may present less risk to them. Apart from the riskier penalty clauses that would be prohibited, individual consumers would retain a potential option to choose between a penalty clause and a higher interest rate. There are legitimate concerns that consumers are not frequently offered a clear and genuine choice. The Board will be seeking to determine through consumer testing whether it can develop a clear and effective disclosure of a consumer's options. There are also legitimate concerns that, no matter how clearly the choice is disclosed, product complexity and other constraints will tend to undermine individual consumer decision making. See part II.C. In this proposal, however, the Board is weighing against such concerns the potential benefit to all consumers in the subprime market from the increased liquidity that prepayment penalties may provide.

Specific Restrictions

Debt-to-income ratio. TILA and Regulation Z prohibit a prepayment penalty on a HOEPA loan if the borrower's DTI ratio at consummation exceeds 50 percent. 15 U.S.C. 1639(c)(2)(A)(i); § 226.32(d)(7)(iii). The Board proposes to apply this rule to higher-priced mortgage loans. Proposed staff comments would give examples of funds and obligations that creditors commonly classify as ''debt'' or ''income.'' Further, the proposal specifies that creditors may, but need not, look to widely accepted governmental and non-governmental underwriting standards to determine how to classify particular funds or obligations as ''debt'' or ''income.'' The Board does not propose to require creditors to use any particular standard for calculating debt or income. A creditor would not violate the prepayment penalty rule if its particular calculation method deviated from those in widely-used underwriting handbooks or manuals, so long as the creditor's method was reasonable.

The 50 percent DTI cap, while not a perfect measure of affordability, may tend to reduce the likelihood that an unaffordable loan will have a prepayment penalty, which would hinder a consumer's ability to exit the

[59] *Improving Mortgage Disclosures,* at 110.

[60] The interagency Statement on Subprime Lending provides that borrowers with certain ARMs should be given a reasonable period of time (typically, at least sixty days) prior to the first rate reset to refinance without penalty. 72 FR 37569, 37574, July 10, 2007.

loan by refinancing the loan or selling the house. Loans with high borrower DTI ratios can be affordable, depending on the borrower's circumstances. A borrower whose DTI ratio exceeds 50 percent at consummation, however, will likely have greater difficulty repaying a particular loan, all other things being equal, than a borrower with a lower DTI ratio.

TILA Section 129(c)(2)(A)(ii) states that the consumer's income and expenses are to be verified by a financial statement signed by the consumer, by a credit report, and in the case of employment income, by payment records or by verification from the employer of the consumer (which verification may be in the form of a copy of a pay stub or other payment record supplied by the consumer). 15 U.S.C. 1639(c)(2)(A)(ii). The Board's proposal, however, does not permit verification of income, whether from employment by another person or self-employment, by a signed statement of the borrower alone. The proposed rule cross-references proposed § 226.35(b)(2)(i), which requires that income relied upon be verified by reasonably reliable third party documents.

There are three bases for the proposal to strengthen the statute's verification requirement. First, under TILA Section 129(l)(2), the Board has a broad authority to update HOEPA's protections as needed to prevent unfair practices. 15 U.S.C. 1639(l)(2)(A). For the reasons discussed in part VII.C., the Board believes that relying on a borrower's statement alone is unfair to consumers, regardless of whether the consumer is employed by another person, self-employed, or unemployed. Second, the Board has a broad authority under Section 129(l)(2) to update HOEPA's protections as needed to prevent their evasion. 15 U.S.C. 1639(l)(2)(A). A signed financial statement declaring all or most of a consumer's income to be self-employment income or income from sources other than employment could be used to evade the statute. Third, adopting a single income verification standard throughout proposed § 226.35(b) would facilitate compliance.

Same creditor. HOEPA does not permit a prepayment penalty on a HOEPA loan if a prepayment is made with amounts obtained by the consumer through a refinancing with the creditor or an affiliate of the creditor. 15 U.S.C. 1639(c)(2)(B). A prohibition on charging a prepayment penalty in the event of a same-lender refinance discourages originators from seeking to ''flip'' the loan. To foreclose evasion by creditors who might direct borrowers to refinance with an affiliated creditor, the same-lender refinance rule covers loans by a creditor's affiliate. The Board requests comment on the effect of imposing the same-creditor restriction on a market where loans are frequently sold.

Five-year limit. HOEPA limits the term of a prepayment penalty on a HOEPA loan to five years after loan origination. 15 U.S.C. 1639(c)(2)(C). The Board believes it would be appropriate to apply the same limitation to prepayment penalties on higher-priced mortgage loans. The Board seeks comment, however, on whether five years is the appropriate limit considering both the need to protect consumers from abuse and the potential benefits of prepayment penalties for consumers. As discussed below, under the proposal a prepayment penalty would have to expire earlier than five years if the payment may increase before then.

Payment increase. In addition to extending the coverage of HOEPA's prepayment penalty restrictions to a broader segment of the market, the Board proposes to require that, for higher-priced mortgage loans, the period during which a penalty may be imposed expire at least sixty days prior to the first date, if any, on which the periodic payment amount *may* increase. Mandatory expiration of the penalty before a possible payment increase would help prevent consumers who had been enticed by a discounted initial payment from being trapped when the payment increased.

The proposed rule would depend on when the rate may increase under the loan agreement, and not on when the rate actually does increase. Although a periodic payment may not actually increase on a rate adjustment date, a creditor may not know whether a borrower's payment will increase in enough time for the creditor to give the borrower a long enough pre-adjustment window in which to refinance without penalty. The proposed bright-line rule would enable creditors and borrowers to know with certainty, at or before loan consummation, the date after which creditors may no longer require a borrower to pay a prepayment penalty.

Periodic payments may increase for a variety of reasons, including a scheduled shift from a discounted interest rate to a fully indexed rate, a change in index value on a non-discounted ARM, or mandatory amortization of principal when deferred principal or interest exceeds a certain threshold. For the sake of simplicity, the proposal would set a single standard for all higher-priced mortgage loans for which periodic payments may increase. For example, if a payment-option ARM allows minimum monthly payments for one year and the first adjustment to the monthly payment is scheduled for one year after origination, a prepayment penalty term would have to end at least sixty days before the end of the first year.

Furthermore, if monthly payments may change before the first scheduled payment adjustment, a prepayment penalty term would have to end at least sixty days before the first date on which such an unscheduled payment change could occur. For instance, the first adjustment on a loan may be scheduled for three years after loan origination, but the creditor may have the right to make an unscheduled payment change if negative amortization causes the loan's principal amount to exceed a certain threshold. In this case, a prepayment penalty could not be charged fewer than sixty days before the first date on which negative amortization possibly could lead to an increase in the borrower's monthly payments.

The mandatory expiration would apply only when *required* payments may increase, not when consumers may opt to pay more than their agreement requires. Moreover, it would not apply to a payment increase due to a borrower's late payment, default, or delinquency.

HMDA data for 2004 through 2006 suggest that a sixty-day period before a payment change would be enough time for a significant majority of subprime borrowers to shop for a new loan to refinance the existing obligation. Creditors report price data on first-lien loans if the difference between a loan's APR and the yield on the comparable Treasury security is equal to or greater than 3 percentage points. For 90 percent of the first-lien higher-priced loans, the period between loan application and origination was less than fifty days. For 75 percent of the first-lien higher-priced loans, the period was less than forty-two days.

Requests for Comment

The Board asks for comment on whether the proposal appropriately balances the potential benefits and potential costs of prepayment penalties to consumers who have higher-priced mortgage loans. The Board asks for specific comment on whether the term allowed for a prepayment penalty should be shorter than five years. Specific comment is also sought on the proposal to strengthen the statute's income verification requirement, and on the potential effects of the same-creditor restriction in a market where creditors sell many of their loans.

The Board also requests comment on the proposal to require that a prepayment penalty period on a higher-priced loan expire at least sixty days prior to the first date on which a periodic payment may increase. In particular, the Board asks for comment on the number of days before a possible payment increase that a prepayment penalty should expire. In addition, the Board solicits comments on whether this provision should apply only to loans whose periodic payment may change within a certain number of years (for example, three or five years) after loan consummation. The Board also seeks comment on whether particular loan types (for example, graduated payment, step-rate, or growth equity transactions) should be exempted from a rule on prepayment penalty expiration.

Comment on these matters is sought both with respect to the subprime market and any part of the alt-A market the proposal may cover. Comment is also sought both with respect to higher-priced mortgage loans and with respect to the sub-category of HOEPA loans.

Notice of Change to Interest Rate and Payment

Under Regulation Z § 226.20(c), an adjustment to the interest rate with or without a corresponding adjustment to the payment in a variable-rate transaction requires new disclosures to the consumer. At least 25, but no more than 120, calendar days before a payment at a new level is due, disclosures must be delivered or placed in the mail that state, among other things, the new rate and payment amount, if any. A notice that combined information about a new payment and interest rate with information about the impending expiration of a prepayment penalty period could potentially benefit consumers.

Reconciling the current notice with the proposed prepayment penalty period could, however, be difficult. For example, some creditors set a consumer's new payment or rate 30 or 45 days before the first possible change in the monthly payment—after the proposal would require a prepayment penalty period to end. Also, notice of expiration might be more clear and conspicuous to a borrower if provided separately from the § 226.20(c) disclosures. Allowing a combined notice might distort borrower decision making. For example, consumers might mistake a notice of their ability to refinance without penalty as a recommendation that they refinance, though their loan may remain affordable and otherwise favorable compared to available alternatives.

An argument can be made that no separate notice of the upcoming expiration of a prepayment penalty period is necessary. Unlike a payment change, the amount of which may remain uncertain until relatively close to the date of any such change, both the creditor and the borrower will have information at loan consummation needed to determine when the prepayment penalty period will expire. On the other hand, consumers may benefit from being reminded when they may prepay without penalty.

The Board proposes to defer revising § 226.20(c) or drafting of new disclosure requirements connected with the proposed prepayment penalty period expiration regulation until the Board proposes comprehensive amendments to Regulation Z's closed-end disclosure provisions. Deferral would enable consumer testing of different disclosure options. In the interim, however, consumers might lack adequate information about when they may prepay without penalty. Accordingly, the Board requests comment on whether, if it adopts the proposed prepayment penalty expiration requirement, the Board should specifically address the requirement's interaction with § 226.20(c).

E. Requirement to Escrow—§ 226.35(b)(4)

The Board proposes to prohibit a creditor from making higher-priced loans secured by a first lien without establishing an escrow account for property taxes and homeowners insurance. Under the proposal, creditors may allow a borrower to ''opt out'' of the escrow, but not at or before consummation, only twelve months after. The proposed rule would appear in § 226.35(b)(4).

Public Comment on Escrows

The June 14, 2007 hearing notice solicited comment on the following questions:

- Should escrows for taxes and insurance be required for subprime mortgage loans?
- If escrows were required, should consumers be permitted to ''opt out'' of escrows?
- Should lenders be required to disclose the absence of escrows to consumers and if so, at what point during a transaction? Should lenders be required to disclose an estimate of the consumer's tax and insurance obligations?
- How would escrow requirements affect consumers and the type of and terms of credit offered?

Consumer and community groups that commented or testified urged the Board to require escrows on subprime loans. They cited the infrequency of escrows in the subprime market—one group cited a statistic in a servicing trade publication indicating that as few as one-quarter of subprime loans have escrow accounts. Commenters stated that escrows have long been a staple of the prime lending market and suggested that borrowers in the subprime market would benefit as much or more if escrows were available or required. They argued that lack of escrows in the subprime market enables originators to advertise and quote low monthly payments that do not include tax and insurance obligations, misleading borrowers, especially first-time homebuyers. Current homeowners whose monthly payments include contributions to an escrow account may believe that the originator who quotes them a payment without escrow contributions can lower the homeowner's mortgage payment. In reality, the payment on the new loan could be as high, or higher, when property taxes and homeowners insurance are taken into account. Commenters also stated that first-time homebuyers as well as current homeowners with escrow accounts may not be aware of the need to save on their own for tax and insurance payments if they are provided loans without escrows. These borrowers may struggle to meet those obligations when they come due, leaving them vulnerable to loan flipping and equity stripping.

Many lenders and financial services trade groups that testified or commented agree that escrowing taxes and insurance is generally beneficial to subprime borrowers as well as lenders, servicers, and investors. Some of these commenters favor a regulation to mandate escrows, assuming it provides them ample time to come into compliance. Some of these commenters, however, would prefer that the Board adopt guidance rather than a regulation to allow flexibility. Other commenters believe that consumers are generally well-enough informed about tax and insurance obligations to save on their own for these payments. These commenters contend that, if escrows were mandated, some potential borrowers would not be able to fund the escrow account at closing.

Discussion

The Board is concerned that the subprime market does not appear to

offer borrowers a genuine opportunity to escrow. Subprime servicers may not set up an escrow infrastructure at all, and subprime originators have disincentives to require or encourage borrowers to take advantage of escrows when they are available. A collective action problem prevails if each individual originator fears that offering escrows would put it at a disadvantage relative to competitors, even if originators collectively would benefit from escrows.[61] Each originator may fear losing business if it escrows. An originator that escrowed would have to quote a monthly payment that included taxes and insurance. Competitors that did not escrow could poach potential or actual customers of the originator by not including taxes and insurance in their quotes. So an originator may be unwilling to escrow without assurance that its competitors also would escrow, though if all originators escrowed then all would likely benefit.

This market failure causes consumers substantial injury. A lack of escrows in the subprime market may make it more likely that borrowers inadvertently take on mortgages they cannot afford because they focus only on the payment of principal and interest. A lack of escrows may also facilitate misleading payment quotes, which distort competition. Lack of escrows also may make it more likely that borrowers who have trouble saving on their own initiative and would prefer a forced saving plan such as an escrow will not have the resources to pay tax and insurance bills when they come due. This problem may be particularly acute in the subprime market, where borrowers are more likely to be cash-strapped. Failure to pay taxes and insurance is generally an act of default which may subject the property to a public auction or an acquisition by a public agency. Borrowers who face a tax or insurance bill they cannot pay are particularly vulnerable to predatory home equity loans because their situation is urgent.

While failure to escrow can cause consumers substantial injury, escrows can also impose costs on consumers. Some borrowers may not be able to afford the cost of funding an escrow at closing. Escrowing also creates an opportunity cost for borrowers who could use the funds for a more productive purpose and still meet their tax and insurance obligations. Some states address this cost at least in part by requiring that an escrow earn interest, but others do not impose such requirements. Moreover, the cost of setting up and administering escrows is passed on at least in part to consumers. The Board has considered these costs in formulating the following proposal.

The Board's Proposal

The Board is proposing to make escrow accounts mandatory on first-lien higher-priced mortgage loans and permit, but not require, creditors to offer borrowers an option to cancel escrows twelve months after consummation. The Board proposes to define ''escrow account'' by reference to the definition of ''escrow account'' in the U.S. Department of Housing and Urban Development's Regulation X (Real Estate Settlement Procedures Act (RESPA)).

The Board believes the proposed remedy for the injuries caused by the subprime market's failure to offer escrow accounts appropriately balances the benefits and costs of escrows. Creditors would have an option to allow consumers to limit the opportunity cost of escrow accounts by opting out after one year. The Board is proposing an ''opt out'' rather than an ''opt in'' regime because ''opt in'' would allow some originators to discourage borrowers from escrowing, creating pressure on other originators to follow suit and leaving the collective action problem unresolved. Moreover, an ''opt out'' available at closing or immediately thereafter would be subject to manipulation. If a consumer could opt out at, or soon after, closing, then some originators might still quote payments without taxes and insurance and tell consumers that they could keep their payments from going up by signing a piece of paper at or shortly after closing. A fairly long period may be required to prevent such circumvention, and to educate borrowers to the benefits of escrowing; the Board proposes twelve months.

Requests for Comment

The Board seeks comment on whether the benefits of the proposed regulation outweigh the costs. Comment is sought both with respect to the subprime market and with respect to any part of the alt-A market this proposal may cover.

The Board also seeks comment on whether creditors should be required, rather than permitted, to allow borrowers to opt out. Comment is also sought on whether a mandatory escrow period different from twelve months would be appropriate, and on whether consumers could effectively be protected from manipulation if the rule permitted them to opt out before closing or soon thereafter.

State Escrow Laws

The Board recognizes that some state laws limit creditors' ability to require escrows. In addition, certain state laws provide consumers a right to cancel an escrow that the consumer may exercise sooner than twelve months after closing. The Board's proposal would not be consistent with such laws and, if adopted, would preempt them to the extent of the inconsistency. The Board seeks information about which state laws would be inconsistent with this proposal.

Other Proposals on Escrows

Other parts of this proposal address other issues with escrows. Proposed § 226.35(b)(1) would require creditors to take into account taxes and insurance when determining whether a borrower can repay a loan. Proposed § 226.24(f)(3)(i)(C) would require advertisements that state a payment amount that does not include taxes and insurance to disclose that in close proximity to the payment amount.

F. Evasion Through Spurious Open-end Credit—§ 226.35(b)(5)

The Board's proposal to exclude HELOCs from the new rules in § 226.35 is discussed in subpart A. above. As noted, the Board recognizes this could lead some creditors to attempt to evade the requirements in § 226.35 by structuring credit as open-end instead of closed-end. Regulation Z § 226.34(b) addresses this risk as to HOEPA coverage by prohibiting structuring a transaction that does not meet the definition of ''open-end credit'' as a HELOC to evade HOEPA. The Board proposes to extend this approach to new § 226.35. Proposed § 226.35(b)(5) would prohibit a creditor from structuring a closed-end transaction—that is, a transaction that does not meet the definition of ''open-end credit''—as a HELOC to evade the limitations in § 226.35.

The Board recognizes that consumers may prefer HELOCs to closed-end home equity loans because of the added flexibility HELOCs provide them. It is not the Board's intention to limit consumers' ability to choose between these two ways of structuring home equity credit. An overly broad anti-evasion rule could potentially limit consumer choices by casting doubt on the validity of legitimate open-end plans. The Board seeks comment on the extent to which the proposed anti-evasion rule could have this consequence, and solicits suggestions

[61] An industry representative at the Board's 2007 hearing indicated that her company's internal analysis showed that escrows clearly improved loan performance. Transcript of HOEPA Hearing at 66 (Jun. 14, 2007), available at *http://www.federalreserve.gov/events/publichearings/hoepa/2007/20070614/transcript.pdf.*

for a more narrowly tailored rule. For example, the primary concern would appear to be with HELOCs that are substituted for closed-end home purchase loans and refinancings, which are usually first-lien loans, rather than with HELOCs taken for home improvement or other consumer purposes. The Board seeks comment on whether it should limit an anti-evasion rule to HELOCs secured by first liens where the consumer draws down all or most of the entire line of credit immediately after the account is opened. Would such a rule be effective in preventing evasion or would it be easily evaded itself?

VIII. Proposed Rules for Mortgage Loans—§ 226.36

Proposed § 226.35, discussed above, would apply certain new protections to higher-priced mortgage loans. In contrast, proposed § 226.36 would apply other new protections to mortgage loans generally, though only if secured by the consumer's principal dwelling. The proposal would prohibit: (1) Creditors from paying mortgage brokers more than an amount the broker disclosed to the consumer in advance as its total compensation; (2) creditors or mortgage brokers from coercing or influencing appraisers to misrepresent the value of a dwelling; and (3) servicers from engaging in unfair fee and billing practices. As with proposed § 226.35, however, proposed § 226.36 would not apply to HELOCs.

A. Creditor Payments to Mortgage Brokers—§ 226.36(a)

The Board proposes to prohibit a creditor from paying a mortgage broker in connection with a covered transaction unless the payment does not exceed an amount the broker has agreed in advance with the consumer will be the broker's total compensation. The agreement must also disclose that the consumer will pay the entire compensation even if all or part is paid directly by the creditor, and that a creditor's payment to a broker can influence the broker to offer the consumer loan terms or products that are not in the consumer's interest or are not the most favorable the consumer could obtain. Creditors could demonstrate compliance with the provision by obtaining a copy of the broker-consumer agreement and ensuring their payment to the broker does not exceed the amount stated in the agreement. The proposal would provide creditors two alternative means to comply, one where the creditor complies with a state law that provides consumers equivalent protection, a second where a creditor can demonstrate that its payments to a mortgage broker are not determined by reference to the transaction's interest rate.

Public Comment on Creditor Payments to Mortgage Brokers

Although the Board did not solicit comment on mortgage broker compensation in its notice of the June 2007 hearing, a number of commenters and some panelists raised the topic. In addition, the Board received information about broker compensation from panelists in the 2006 hearings.

Consumer and creditor representatives alike have raised concerns about the fairness and transparency of creditor payments to brokers, known as yield spread premiums. Several commenters and panelists stated that consumers are not aware of the payments creditors make to brokers, or that such payments increase consumers' interest rates. They also stated that consumers may mistakenly believe that a broker seeks to obtain the best interest rate available. Consumer groups have expressed particular concern about increased payments to brokers for delivering loans both with higher interest rates and prepayment penalties. Consumer groups suggested, variously, prohibiting creditors paying brokers yield spread premiums, imposing on brokers that accept yield spread premiums a fiduciary duty to consumers, imposing on creditors that pay yield spread premiums liability for broker misconduct, or including yield spread premiums in the points and fees test for HOEPA coverage. Several creditors and creditor trade associations advocated requiring brokers to disclose whether the broker represents the consumer's interests, and how and by whom the broker is to be compensated. Some of these commenters recommended requiring brokers to disclose their total compensation to the consumer and prohibiting creditors from paying brokers more than the disclosed amount.

Discussion

A yield spread premium is the present dollar value of the difference between the lowest interest rate the wholesale lender would have accepted on a particular transaction and the interest rate the broker actually obtained for the lender. This dollar amount is usually paid to the mortgage broker, though it may also be applied to other closing costs. (This proposal would restrict only amounts paid to and retained by the broker, however, and not amounts the broker is obligated to pass on to other settlement service providers.) The creditor's payment to the broker based on the interest rate is an alternative to the consumer's paying the broker directly from the consumer's preexisting resources or from the loan proceeds. Preexisting resources or loan proceeds may not be sufficient to cover the broker's total fee, or may appear to the consumer to be a more costly way to finance those costs if the consumer expects to prepay the loan in a relatively short period. Thus, consumers potentially benefit from having an option to pay brokers for their services indirectly by accepting a higher interest rate.

The Board shares concerns, however, that creditor payments to mortgage brokers are not transparent to consumers and are potentially unfair to them. Creditor payments to brokers based on the interest rate give brokers an incentive to provide consumers loans with higher interest rates. Some brokers may refrain from acting on this incentive out of legal, business, or ethical considerations. Moreover, competition in the mortgage loan market may often limit brokers' ability to act on the incentive. The market often leaves brokers room to act on the incentive should they choose, however, especially as to consumers who are less sophisticated and less likely to shop among either loans or brokers.

Large numbers of consumers are simply not aware the incentive exists. Many consumers do not know that creditors pay brokers based on the interest rate, and current legally required disclosures seem to have only limited effect.[62] Some consumers may not even know that creditors pay brokers: a common broker practice of charging a small part of its compensation directly to the consumer, to be paid from the consumer's existing resources or loan proceeds, may lead consumers to believe, incorrectly, that this amount is all the consumer will pay or the broker will receive. Consumers who do understand that the creditor pays the broker based on the interest rate may not fully understand the implications of the practice. They may not appreciate the full extent of the incentive this gives the broker to increase the rate because they do not

[62] This is true not only of state-mandated disclosures but also of the early federal disclosure currently in place under the Real Estate Settlement Procedures Act (RESPA), the good faith estimate of settlement costs (GFE). As the Department of Housing and Urban Development (HUD) has noted, the current GFE does not convey to consumers an adequate understanding of how mortgage brokers are paid. RESPA Simplification, 67 FR 49134, 49140–41, Jul. 29, 2002 (proposed rule under RESPA).

know the dollar amount of the creditor's payment.

Moreover, consumers often wrongly believe that brokers agree, or are required, to obtain the best interest rate available. Several commenters in connection with the 2006 hearings suggested that mortgage broker marketing cultivates an image of the broker as a ''trusted advisor'' to the consumer. Consumers who have this perception may rely heavily on a broker's advice, and there is some evidence that such reliance is common. In a 2003 survey of older borrowers who had obtained prime or subprime refinancings, seventy percent of respondents with broker-originated refinance loans reported that they had relied ''a lot'' on their brokers to find the best mortgage for them.[63]

If consumers believe that brokers protect consumers' interests by shopping for the lowest rates available, then consumers will be less likely to take steps to protect their own interests when dealing with a broker. For example, they may be less likely to shop rates across retail and wholesale channels simultaneously to assure themselves the broker is providing a competitive rate. They may also be less likely to shop and negotiate brokers' services, obligations, or compensation up-front, or at all. For example, they may be less likely to seek out brokers who will promise in writing to obtain the lowest rate available.

The Board's Proposal

The Board proposes to prohibit a creditor from paying a mortgage broker in connection with a covered transaction unless the payment does not exceed an amount the broker has agreed with the consumer in advance will be the broker's total compensation. The proposal would restrict only amounts the broker retains, not amounts the broker distributes to other settlement service providers. The agreement must also disclose that the consumer will pay the entire compensation even if all or part is paid directly by the creditor, and that a creditor's payment to a broker can influence the broker to offer the consumer loan terms or products that are not in the consumer's interest or are not the most favorable the consumer could obtain. The commentary would provide model language for each of these disclosures, which the Board anticipates testing with consumers. The broker and consumer must have entered into the agreement before the consumer had paid a fee to any person or submitted a written application to the broker, whichever occurred earlier.

The proposal is intended to limit the potential for unfairness, deception, and abuse in creditor payments to brokers in exchange for higher interest rates while preserving this option for consumers to finance their obligations to brokers. Conditioning such payments on a broker's advance commitment to the consumer to limit its compensation to a specified dollar amount may increase transparency and improve competition in the market for brokerage services. Improved competition could lower the price of brokerage services, improve the quality of those services, or both. When consumers are aware how much they will pay for a broker's services, they may be more likely to shop and negotiate among brokers based on broker fees, broker services, and other terms of broker contracts.

Disclosing that the consumer ultimately pays the broker's compensation would help ensure that the disclosure of a compensation figure was meaningful and not undermined by a consumer's perception that the creditor, not the consumer, shoulders the broker fee. Disclosing that the creditor's payment may influence the broker not to serve the best interests of the consumer would help ensure that consumers were on notice of the need to protect their own interests when dealing with a mortgage broker rather than assume that the broker would fully protect their interests.

The rule is intended to impose a fairly minimal compliance burden. A creditor would demonstrate compliance by obtaining a copy of a timely executed broker-consumer agreement and ensuring that it did not pay the broker more than the amount stated in the agreement, reduced by any amount paid directly by the consumer. The amount paid directly by the consumer, if any, would appear on the HUD–1 Settlement Statement prepared in accordance with the Real Estate Settlement Procedures Act.

The Board considered imposing a disclosure obligation directly on brokers. It does not appear, however, that a disclosure alone would provide consumers adequate protection. More protection is provided where creditors are prohibited from paying more than the amount disclosed.

Compensation amount. The proposal would require that the compensation be disclosed as a flat dollar amount. The proposal would not permit disclosing a range of fees or a percentage figure. The Board recognizes that disclosure in these or other forms has been common. The Board is concerned, however, that disclosure in a form other than a flat dollar amount, however, would not be meaningful to consumers.

Timing. The proposal would require that the broker-consumer agreement have been entered into before the consumer pays a fee to any person in connection with the transaction or submits an application. This is intended to ensure the consumer has not already become ''locked in'' to a relationship with the broker by paying a fee or submitting an application. The early timing requirement may also tend to limit the risk that a broker would price discriminate on the basis of the sophistication and market options of the borrower.

The Board recognizes that requiring a broker who seeks to be paid by the creditor to commit to its fee this early in its relationship with the consumer may lead brokers to price their services on the basis of the average cost of a transaction rather than separately for each transaction. Average cost pricing can potentially create some inefficiency. The Board believes, however, that this cost may be outweighed by the increased efficiency from improved transparency.

Loans covered. The proposed rule would apply to the prime market as well as the subprime market. The Board recognizes that injury to consumers in the prime market is likely more limited than injury in the subprime market because loans in the prime market have a much narrower range of interest rates, which limits the rents that can be extracted from consumers. The Board is concerned, however, that the lack of transparency discussed above may injure borrowers in the prime market, too, even if not to the same degree.

Originators covered. The proposal is limited to creditor payments to brokers. A broker would be defined as a person, other than a creditor's employee, who for monetary gain arranges, negotiates, or otherwise obtains an extension of credit for a consumer. See proposed § 226.36(c). A person who met this definition would be considered a mortgage broker even if the credit obligation was initially payable to the person, unless the person funded the transaction from its own resources, from deposits, or from a bona fide warehouse line of credit.

The Board is aware of concerns that a rule restricting, and encouraging disclosure of, lender payments to brokers but not lender payments to their

[63] Kellie K. Kim-Sung & Sharon Hermanson, *Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans,* Data Digest No. 83 (AARP Public Policy Inst., Washington, D.C.), Jan. 2003, at 3, available at *http://www.aarp.org/research/credit-debt/mortgages/experiences_of_older_refinance_mortgage_loan_borro.html.*

employees could create an ''uneven playing field'' between brokers and lenders. Creditors sometimes pay their employed loan officers on a basis similar to their payment of yield spread premiums to independent brokers. To the extent a loan originated through an employee exceeds the creditor's ''par'' rate, the creditor may realize a gain from selling the loan on the secondary market and it may share some of this gain with the employee. Such payments give employees an incentive to increase the interest rate.

The Board does not propose, however, to restrict creditor payments to their own employees. The Board is not aware of significant evidence that consumers perceive lenders' employees the way they often perceive independent brokers—as trusted advisors who shop for the best loan for a consumer among a wide variety of sources. Accordingly, it is not clear that a key premise of the proposal to restrict creditor payments to brokers—that consumers expect a broker has a legal or professional obligation to give disinterested advice and find the consumer the best loan available—holds true for creditor payments to their own employees. In addition, extending the proposal to creditor payments to their employees could present difficult practical problems. For example, a creditor may not know even as of consummation whether it will sell a particular loan in the secondary market. If the creditor is nonetheless certain to sell the loan, it may not know until near or at consummation what its gain will be or, therefore, how much it will pay its employee.

Compliance alternatives. The proposal would provide creditors two alternative ways to comply, one where the creditor complies with a state law that provides consumers equivalent protection, a second where a creditor can demonstrate that its payments to a mortgage broker are not determined by reference to the transaction's interest rate. The first safe harbor is for a creditor payment to a broker for a transaction in connection with a state statute or regulation that (a) expressly prohibits the broker from being compensated in a manner that would influence a broker to offer loan products or terms not in the consumer's interest or not the most favorable the consumer could obtain; and (b) requires that a mortgage broker provide consumers with a written agreement that includes a description of the mortgage broker's role in the transaction and the broker's relationship to the consumer, as defined by such statute or regulation. An example would be a state statute or regulation that imposed a fiduciary obligation on a mortgage broker not to puts its own interests ahead of the consumer's and required the broker to disclose this obligation in an agreement with the consumer.

The second alternative is for a creditor that can demonstrate that the compensation it pays to a mortgage broker in connection with a transaction is not determined, in whole or in part, by reference to the transaction's interest rate. For instance, if a creditor can show that it pays brokers the same flat fee for all transactions regardless of the interest rate, the creditor would not be subject to the restriction on payments to brokers under § 226.36(a)(1).

Requests for Comment

The Board seeks comment generally on the costs and benefits of the proposal, including the proposed alternatives means of compliance. The Board seeks specific comment on whether it would be appropriate to apply the proposed rule, or a similar rule, to lender payments to loan originators in their employ and, if so, how the rule would address practical difficulties such as those discussed above. Further, the Board seeks comment on whether the benefits of applying the proposed rule to the prime market would outweigh the costs, including potential unintended consequences. The Board seeks specific comment on whether the proposed rule should be limited to higher-priced mortgage loans as defined in proposed § 226.35(a).

The Board also seeks comment on the proposed condition that the broker-consumer agreement have been entered into before the consumer pays a fee to any person in connection with the transaction or submits an application. Would brokers have a reduced incentive to shop actively among potential sources of financing for the lowest possible rate? Would a broker potentially terminate its relationship with a consumer without obtaining a loan for the consumer because the consumer's particular needs would be more difficult to meet than the broker anticipated when it set its compensation? If these are concerns, would it be appropriate for the Board to provide a narrow allowance for renegotiation of the broker's compensation later in the application process? How should such a permission be crafted to ensure transparency and protect consumers from unfair practices such as ''bait and switch''?

The Proposed Rule's Relationship to Other Laws

The Board recognizes that HUD has issued policy statements regarding creditor payments to mortgage brokers under RESPA and guidance as to disclosure of such payments on the Good Faith Estimate and HUD–1 Settlement Statement. The Board is also aware that HUD has announced its intention to propose improved disclosures for broker compensation under RESPA in the near future. The Board intends that its proposal would complement any proposal by HUD and operate in combination with that proposal to meet the agencies' shared objectives of fair and transparent markets for mortgage loans and for mortgage brokerage services. The Board and HUD have discussed their mutual desire and intention to work together to achieve these objectives while minimizing any duplication between their regulations. Accordingly, the proposed restriction of creditor payments to mortgage brokers is intended to be consistent with HUD's existing guidance regarding creditor compensation to brokers under Section 8 of RESPA, 12 U.S.C. 2607.

The Board is also aware that many states regulate brokers and their compensation in various respects. Under TILA Section 111, the proposed rule would not preempt such state laws except to the extent they are inconsistent with the proposal's requirements. 15 U.S.C. 1610. The Board seeks comment on the relationship of this proposal to state laws.

B. Coercion of Appraisers—§ 226.36(b)

The Board proposes to prohibit creditors and mortgage brokers from coercing appraisers to misrepresent the value of a consumer's principal dwelling. The Board also proposes to prohibit creditors from extending credit when creditors know or have reason to know, at or before loan consummation, that an appraiser has misstated a dwelling's value. The regulation would apply to all consumer credit transactions secured by a consumer's principal dwelling.

Discussion

Some responses to the Board's request for public comment urged the Board to address coercion of appraisers, even though the Board did not specifically request comment on that issue. For example, the National Association of Attorneys General and many consumer and community groups cited inflated appraisals as a problem in the home

mortgage market. A lender trade association suggested that the Board require appraisers to report instances of improper pressure and ban inflation of appraisals. Appraiser trade associations and several consumer and community groups urged the Board to prohibit coercion of appraisers as an unfair or deceptive act or practice. Also, testimony before Congress has cited data that suggests that appraisers frequently are subject to coercion.[64]

Pressuring an appraiser to overstate, or understate, the value of a consumer's dwelling distorts the lending process and harms consumers. If the appraisal is inflated on a home purchase loan, a consumer may pay more for the house than the consumer otherwise would have. Inflated appraisals also may lead consumers to think they have more equity in their homes than they really have, and consumers may borrow or make other financial decisions based on this incorrect information. For example, a consumer who purchases a home based on an inflated appraisal may overestimate her ability to refinance and may take on a riskier loan than she otherwise would have. Moreover, the consumer would not necessarily be aware that an appraisal had been inflated or appreciate the risk that appraisal inflation entailed. Understated appraisals, though perhaps less common, can cause consumers to be denied access to credit for which they were qualified.

Inflated appraisals of homes concentrated in a neighborhood may affect other appraisals, since appraisers factor the value of comparable properties into their property valuation. For the same reason, understated appraisals may affect appraisals of neighboring properties. Thus, inflated or understated appraisals can harm consumers other than those who are party to the transaction with the inflated appraisal. Moreover, these consumers are not in a position to know of the practice or avoid it.

State legislatures and enforcement agencies have addressed concerns about parties who exert undue influence over appraisers' property valuations.[65] Several states have banned coercion of appraisers or enacted general laws against mortgage fraud that may be used to combat appraiser coercion.[66] In 2006, forty-nine states and the District of Columbia (collectively, the Settling States) entered into a settlement agreement with ACC Capital Holdings Corporation and several of its subsidiaries, including Ameriquest Mortgage Company (collectively, the Ameriquest Parties). The Settling States alleged that the Ameriquest Parties had engaged in deceptive or misleading acts that resulted in the Ameriquest Parties' obtaining inflated appraisals of homes' value.[67] To settle the complaints, the Ameriquest Parties agreed to abide by policies designed to ensure appraiser independence and accurate valuations. Also, the Attorneys General of New York and Ohio recently have filed actions that allege, among other violations, the exertion of improper influence over appraisers.

The Board's Proposal

To address the harm from improper influencing of appraisers, the Board proposes to prohibit creditors and mortgage brokers and their affiliates from pressuring an appraiser to misrepresent a dwelling's value, for all closed-end consumer credit transactions secured by a consumer's principal dwelling. The proposed regulation defines the term ''appraiser'' as a person who engages in the business of providing, or offering to provide, assessments of the value of dwellings.

Further, the Board's proposed regulation prohibits a creditor from extending credit if the creditor knew or had reason to know that a broker had coerced an appraiser to misstate a dwelling's value, unless the creditor acted with reasonable diligence to determine that the appraisal was accurate. For example, an appraiser might notify a creditor that a mortgage broker had tried—and failed—to get the appraiser to inflate a dwelling's value. If, after reasonable, documented investigation, the creditor found that the appraiser had not misstated the dwelling's value, the creditor could extend credit based on the appraiser's valuation. The proposed commentary states that, alternatively, the creditor could extend credit based on another appraisal untainted by improper influence.

The commentary to the proposed regulation gives examples of acts that would violate the regulation: implying to an appraiser that retention of the appraiser depends on the amount at which the appraiser values a consumer's principal dwelling; failing to compensate an appraiser or to retain the appraiser in the future because the appraiser does not value a consumer's principal dwelling at or above a certain amount; and conditioning an appraiser's compensation on loan consummation. The commentary also lists examples of acts that would not violate the regulation: requesting that an appraiser consider additional information for, provide additional information about, or correct factual errors in a valuation; obtaining multiple appraisals of a dwelling (provided that the creditor or mortgage broker selects appraisals based on reliability rather than on the value stated); withholding compensation from an appraiser for breach of contract or substandard performance of services or terminating a relationship for violation of legal or ethical standards; and taking action permitted or required by applicable federal or state statute, regulation, or agency guidance.

A regulation under HOEPA that expressly prohibits creditors and brokers from pressuring appraisers to misstate or misrepresent the value of a consumer's dwelling would provide enforcement agencies in every state with a specific legal basis for an action alleging appraiser coercion. The Board requests comments on the potential costs and benefits of its proposed appraiser influence regulation. The Board seeks specific comment on the appropriateness of proposed examples of actions that would or would not violate the proposed regulation.

C. Servicing Abuses—§ 226.36(d)

The Board proposes to prohibit certain practices on the part of servicers of closed-end consumer credit transactions secured by a consumer's principal dwelling. Proposed § 226.36(d) would provide that no servicer shall: (1) Fail to credit a consumer's periodic payment as of the date received; (2) impose a late fee or delinquency charge where the only late fee or delinquency charge is due to a consumer's failure to include in a current payment a delinquency charge imposed on earlier payments; (3) fail to

[64] For example, on June 26, 2007, at a hearing of the U.S. Senate Committee on Banking, the President of the Appraisal Institute testified for several appraiser trade organizations about threats to appraiser independence. He cited a 2007 survey by the October Research Corporation that found that 90 percent of appraisers reported having been pressured to report higher property values, a percentage almost twice as high as reported in a 2003 survey. *Ending Mortgage Abuse: Safeguarding Homebuyers: Hearing before the Subcomm. on Hous., Transp., & Comm'y Dev. of the S. Comm. on Banking, Hous., and Urban Affairs* 4, 110th Cong. (2007) (statement of Alan Hummel, Chair, Government Relations Committee, Appraisal Institute).

[65] The federal financial institution regulatory agencies have issued regulations to the institutions they supervise that explain, among other things, how those institutions should promote appraiser independence. The Board's proposal is not intended to alter those regulations or any other federal or state statutes, regulations, or agency guidance related to appraisals.

[66] *See, e.g.*, Colo. Rev. Stat. § 6–1–717; Iowa Code § 543D.18A; Ohio Rev. Code Ann. §§ 1322.07(G), 1345.031(B)(10), 4763.12(E).

[67] *See, e.g., Iowa ex rel. Miller* v. *Ameriquest Mortgage Co.,* No. 05771 EQCE–053090 (Iowa D. Ct. 2006) (Pls. Pet. 5).

provide a current schedule of servicing fees and charges within a reasonable time of request; or (4) fail to provide an accurate payoff statement within a reasonable time of request.

Discussion

Although the Board did not solicit comment on whether certain mortgage servicer practices should be prohibited or restricted in its notices of the 2006 or 2007 hearings, some commenters raised the topic in that context. The issue has also been presented in recent congressional testimony. Consumer advocates have raised concerns that some servicers may be charging consumers unwarranted or excessive fees, such as late fees and other ''service'' fees, in the normal course of mortgage servicing, as well as in foreclosure scenarios. There is anecdotal evidence that significant numbers of consumers have complained about servicing practices, and instances of unfair practices have been cited in court cases.[68] In 2003, the FTC announced a $40 million settlement with a large mortgage servicer and its affiliates to address allegations of abusive behavior.[69] Consumer advocates have also raised concerns that consumers are sometimes unable to understand the basis upon which fees are charged, in part because disclosure and other forms of notice to consumers of servicer fees are limited.

The Board shares concerns about abusive servicing practices. Before securitization became commonplace, a lending institution would often act as both originator and collector—that is, it would service its own loans. Today, however, separate servicing companies play a key role: they are chiefly responsible for account maintenance activities, including collecting payments (and remitting amounts due to investors), handling interest rate adjustments, and managing delinquencies or foreclosures. Servicers also act as the primary point of contact for consumers. In exchange for performing these services, servicers generally receive a fixed per-loan or monthly fee, float income, and ancillary fees—including default charges—that the consumer must pay.

A potential consequence of the ''originate-to-distribute'' model discussed in part II.C. above is the misalignment of incentives between consumers, servicers, and investors. Servicers contract directly with investors, and consumers are not a party to the contract. The investor is principally concerned with maximizing returns on the mortgage loans. So long as returns are maximized, the investor may be indifferent to the fees the servicer charges the borrower. Consumers do not have the ability to shop for servicers and have no ability to change servicers (without refinancing). As a result, servicers do not compete in any direct sense for consumers. Thus, there may not be sufficient market pressure on servicers to ensure competitive practices.

As a result, as described above, substantial anecdotal evidence of servicer abuse exists. For example, servicers may not timely credit, or may misapply, payments, resulting in improper late fees. Even where the first late fee is properly assessed, servicers may apply future payments to the late fee first, making it appear future payments are delinquent even though they are, in fact, paid in full within the required time period, and permitting the servicer to charge additional late fees—a practice commonly referred to as ''pyramiding'' of late fees. The Board is also concerned about the transparency of servicer fees and charges, especially because consumers may have no notices of such charges prior to their assessment. Consumers may be faced with charges that are confusing, excessive, or cannot easily be linked to a particular service. In addition, servicers may fail to provide payoff statements in a timely fashion, thus impeding consumers from refinancing existing loans.

The Board's Proposal

The Board is proposing to restrict certain servicing practices and to provide more transparency in the servicing market. Proposed § 226.36(d) would prohibit four servicing practices that are likely to harm consumers. First, the proposal would prohibit a servicer from failing to credit a payment to a consumer's account as of the same date it is received. Second, the proposal would prohibit ''pyramiding'' of late fees, by prohibiting a servicer from imposing a late fee on a consumer for making an otherwise timely payment that would be the full amount currently due but for its failure to include a previously assessed late fee. Third, the proposal would prohibit a servicer from failing to provide to a consumer, within a reasonable time after receiving a request, a schedule of all specific fees and charges it imposes in connection with mortgage loans it services, including the dollar amount and an explanation of each fee and the circumstances under which it will be imposed. Fourth, the proposal would prohibit a servicer from failing to provide, within a reasonable time after receiving a request, an accurate statement of the amount currently required to pay the obligation it services in full, often referred to as a payoff statement. Under proposed § 226.36(d)(3), the term ''servicer'' and ''servicing'' are given the same meanings as provided in Regulation X, 24 CFR 3500.2.

As described in part V above, TILA Section 129(l)(2) authorizes protections against unfair practices by non-creditors and against unfair or deceptive practices outside of the origination process, when such practices are ''in connection with mortgage loans.'' 15 U.S.C. 1639(l)(2). The Board believes that unfair or deceptive servicing practices fall squarely within the purview of Section 129(l)(2) because servicing is an integral part of the life of a mortgage loan and, therefore, has a close and direct ''connection with mortgage loans.'' Accordingly, the Board bases its proposal to prohibit certain unfair or deceptive servicing practices on its authority under Section 129(l)(2), 15 U.S.C. 1639(l)(2).

Late Payments

The proposed rule prohibiting the failure to credit payments as of the date received would be substantially similar to the existing provision requiring prompt crediting of payment on open-end transactions in § 226.10. Accordingly, proposed § 226.36(d)(1)(i) would require a servicer to credit a payment to the consumer's loan account as of the date of receipt, except when a delay in crediting does not result in a finance or other charge or in the reporting of negative information to a consumer reporting agency except as provided in § 226.36(d)(2). As the proposed commentary would make clear, the proposal would not require that a servicer physically enter the payment on the date received, but would require only that it be credited *as of* the date received. Thus, a servicer that receives a payment on or before its due date and does not enter the payment on its books until after the due date does not violate the requirement as long as the entry does not result in the imposition of a late charge, interest, or

[68] *See, e.g., Islam* v. *Option One Mortgage Corp.,* 432 F. Supp. 2d 181 (D. Mass 2006); *In Re Coates,* 292 B.R. 894 (D. Ill. 2003); *In Re Gorshstein,* 285 B.R. 118 (S.D.N.Y. 2002); *In re Tate,* 253 B.R. 653 (2000); *Rawlings* v. *Dovenmuehle Mortgage Inc.,* 64 F. Supp. 2d 1156 (M.D. Ala. 1999); *Ronemus* v. *FTB Mortgage Servs.,* 201 B.R. 458 (1996).

[69] Consent Order, *United States* v. *Fairbanks Capital Corp.,* Civ. No. 03–12219-DPW (D. Mass Nov. 21, 2003, as modified Sept. 4, 2007). *See also Ocwen Federal Bank FSB,* Supervisory Agreement, OTS Docket No. 04592 (Apr. 19, 2004) (settlement resolving mortgage servicing issues).

other charge to the consumer. The Board seeks comment on whether (and if so, how) partial payments should be addressed in this provision.

Similar to § 226.10(b), proposed § 226.36(d)(2) would require a servicer that specifies payment requirements in writing, but that accepts a non-conforming payment, to credit the payment within five days of receipt. The proposed commentary is also similar to the commentary accompanying § 226.10(b); for example, it explains that the servicer may specify in writing reasonable requirements for making payments, such as setting a cut-off hour for payment to be received. The Board seeks comment on whether the commentary should include a safe harbor as to what constitutes a reasonable payment requirement, for example, a cut-off time of 5 p.m. for receipt of a mailed check.

Pyramiding Late Fees

The prohibition on pyramiding late fees parallels the existing prohibition in the ''credit practices rule,'' under section 5 of the FTC Act, 15 U.S.C. 45. *See, e.g.*, 12 CFR 227.15 (Board's Regulation AA). Proposed § 226.36(d)(1)(ii) would prohibit servicers from imposing any late fee or delinquency charge on the consumer in connection with a payment, when the only delinquency is attributable to late fees or delinquency charges assessed on an earlier payment, and the payment is otherwise a full payment for the applicable period and is paid on its due date or within an applicable grace period. The proposed commentary provides that the prohibition should be construed consistently with the credit practices rule. Servicers are currently subject to this rule, whether they are banks (Regulation AA), thrifts (12 CFR 535.4), or other kinds of institutions (16 CFR 444.4). Consumers may nevertheless benefit if the Board adopted the same requirement under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2). This would permit state attorneys general to enforce the rule uniformly, where currently they may be limited to enforcing the rule through state statutes that may vary. Accordingly, violations of the anti-pyramiding rule by servicers would provide state attorneys general an additional means of enforcement.

Schedule of Fees and Charges

The third proposed rule would require a servicer to provide to a consumer upon request a schedule of all specific fees and charges that may be imposed in connection with the servicing of the consumer's account, including a dollar amount and an explanation of each and the circumstances under which it may be imposed. The Board believes that making the fee schedule available to consumers upon request will bring transparency to the market and will make it more difficult for unscrupulous servicers to camouflage or inflate fees. Therefore, the proposal would require the servicer to provide, upon request, a fee schedule that is specific both as to the amount and reason for each charge, to prevent servicers from disguising fees by lumping them together or giving them generic names.

The proposed commentary would also explain that a dollar amount may be expressed as a flat fee or, if a flat fee is not feasible, as an hourly rate or percentage. Thus, if the services of a foreclosure attorney are required, the servicer might list the attorney's hourly rate because it would be difficult for a servicer to determine a flat dollar amount. However, it might not be difficult for a servicer to determine a flat delivery service fee. The Board believes that disclosure of a dollar figure for each fee will discourage abusive servicing practices by enhancing the consumer's understanding of servicing charges. The Board seeks comment on the effectiveness of this approach, and on any alternative methods to achieve the same objective.

Further, the proposed commentary would clarify that ''fees imposed'' by the servicer include third party fees or charges passed on by the servicer to the consumer. The Board recognizes that servicers may have difficulty identifying third party charges with complete certainty, because third party fees may vary depending on the circumstances (for example, fees may vary by geography). The Board seeks comment on whether the benefit of increasing the transparency of third party charges would outweigh the costs associated with a servicer's uncertainty as to such charges.

The proposed commentary would clarify that a servicer who receives a request for the schedule of fees may either mail the schedule to the consumer or direct the consumer to a specific Web site where the schedule is located. The Board believes that having the option to post the schedule on a Web site will greatly reduce the burden on servicers to provide schedules. However, the proposed commentary provides that any such Web site address reference must be specific enough to inform the consumer where the schedule is located, rather than solely referring to the servicer's home page.

Loan Payoff Statement

Proposed § 226.36(d)(1)(iv) would prohibit a servicer from failing to provide, within a reasonable time after receiving a request from the consumer or any person acting on behalf of the consumer, an accurate statement of the full amount required to pay the obligation in full as of a specified date, often referred to as a payoff statement. Servicers' delay in providing payoff statements has impeded consumers from refinancing existing loans or otherwise clearing title. Such delays increase transaction costs and may discourage consumers from pursuing a refinance opportunity. The proposed commentary states that under normal market conditions, three business days would be a reasonable time to provide the payoff statements; however, the commentary states that a reasonable time might be longer than three business days when servicers are experiencing an unusually high volume of refinancing requests.

Under this provision, the servicer would be required to respond to the request of a person acting on behalf of the consumer; this is to ensure that the creditor with whom the consumer is refinancing receives the payoff statement in a timely manner. It also ensures that others who act on the consumer's behalf, such as a non-profit homeownership counselor, can obtain a payoff statement for the consumer within a reasonable time.

D. Coverage—§ 226.36(e)

Proposed § 226.36 would apply new protections to mortgage loans generally, if primarily for a consumer purpose and secured by the consumer's principal dwelling, because the Board believes that the concerns addressed by proposed § 226.36 also apply to the prime market. However, the Board proposes to exclude HELOCs from coverage of § 226.36 because the risks to consumers addressed by the proposal may be lower in connection with HELOCs than with closed-end transactions. Most originators of HELOCs hold them in portfolio rather than sell them, which aligns these originators' interests in loan performance more closely with their borrowers' interests. Further, consumers with HELOCs can be protected in other ways besides regulation under HOEPA. Unlike closed-end transactions, HELOCs are concentrated in the banking and thrift industries, where the federal banking agencies can use their supervisory authority to protect

consumers.[70] Similarly, TILA and Regulation Z already contain a prompt crediting rule for HELOCs, 12 CFR 226.10, of the kind the Board is proposing in § 226.36(d).

The Board seeks comment on whether there is a need to apply any or all of the proposed prohibitions in § 226.36 to HELOCs. For example, one source reports that the proportion of HELOCs originated through mortgage brokers is quite small.[71] This may suggest that the risks of improper creditor payments to brokers or broker coercion of appraisers in connection with HELOCs is limited. Are mortgage brokers growing as a channel for HELOC origination such that regulation under §§ 226.36(a) through 226.36(c) is necessary? Do originators contract out HELOC servicing often enough to necessitate the proposed protections of § 226.36(d)? If coverage should be extended to HELOCs, the Board also solicits comment as to whether such coverage should be limited to specific types of HELOCs. For example, do purchase money HELOCs, which are often used in combination with first-lien closed-end loans to purchase a home, mirror the risks associated with first-lien loans?

IX. Other Potential Concerns

A. Other HOEPA Prohibitions

As discussed in part VII, the Board is proposing to extend to higher-priced mortgage loans two of the restrictions HOEPA currently applies only to HOEPA loans, concerning determinations of repayment ability and prepayment penalties. *See* TILA Section 129(c) and (h), 15 U.S.C. 1639(c) and (h). HOEPA also prohibits negative amortization, interest rate increases after default, balloon payments on loans with a term of less than five years, and prepaid payments. TILA Section 129(d)–(g), 15 U.S.C. 1639(d)–(g). In addition, the statute prohibits creditors from paying home improvement contractors directly unless the consumer consents in writing. TILA Section 129(j), 15 U.S.C. 1639(j). In 2002, the Board added to these limitations on HOEPA loans a regulatory prohibition on due-on-demand clauses and on refinancings by the same creditor (or assignee) within one year unless the refinancing is in the borrower's interest. 12 CFR 226.32(d)(8) and 226.34(a)(3).

The Board seeks comment on whether any of these restrictions should be applied to higher-priced mortgage loans. Is there evidence that any of these practices has caused consumers in the subprime market substantial injury or has the potential to do so? Would the benefits of applying the restriction to higher-priced mortgage loans outweigh the costs, considering both the subprime market and the part of the alt-A market that may be covered by the proposal?

Negative amortization has been a particular concern in recent years because of the rapid spread of nontraditional mortgages that permit consumers to defer for a time paying any principal and to pay less than the interest due. What are the costs and benefits for consumers of negative amortization in the part of the market that would be covered under the definition of higher-priced mortgage loans? Would proposed § 226.35(b)(1), which would generally prohibit a pattern or practice of extending higher-priced mortgage loans without regard to consumers' repayment ability—taking into account a fully-amortizing payment—adequately address concerns about negative amortization on such loans?

Historically, loans with balloon payments also have been of concern in the subprime market. What are the costs and benefits for consumers of balloon loans in the part of the market that would be covered under the definition of higher-priced mortgage loans? Should the Board prohibit balloon payments with such loans and, if so, should balloon payments be permitted on loans with terms of more than five years, as HOEPA now permits? Proposed § 226.35(b)(1) would provide creditors a safe harbor from the prohibition against a pattern or practice of lending without regard to repayment ability if the creditor has a reasonable basis to believe consumers will be able to make loan payments for at least seven years after consummation of the transaction. Would this safe harbor tend to encourage creditors to restrict balloon payments to the eighth year, or later? If so, would the proposal provide consumers adequate protections from balloon loans without a regulation specifically addressing them?

B. Steering

Consumer advocates and others have expressed concern that borrowers are sometimes steered into loans with prices higher than the borrowers' risk profiles warrant or terms and features not suitable to the borrower. Existing law also restricts steering. If a creditor steered borrowers to higher-rate loans or to certain loan products on the basis of borrowers' race, ethnicity, or other prohibited factors, the creditor would violate the Equal Credit Opportunity Act, 15 U.S.C. 1601 *et seq.*, and Regulation B, 12 CFR 202, as well as the Fair Housing Act, 42 U.S.C. 3601 *et seq.*

Moreover, two parts of this proposal would help to address steering regardless whether the steering had a racial basis or other prohibited basis. First, proposed § 226.36(a) would limit creditor payments to mortgage brokers to an amount the broker had agreed with the consumer in advance—before the broker could know what rate the consumer would qualify for—would be the broker's total compensation. This provision also would prohibit the payment unless the broker had given the consumer a written notice that a broker that receives payments from a creditor may have incentives not to provide the consumer the best or most suitable rates or terms. These restrictions are intended to reduce the incentive and ability of a mortgage broker to offer a consumer a higher rate simply so that the broker, without the consumer's knowledge, could receive a larger payment from the creditor. Second, proposed § 226.35(b)(1) would prohibit a creditor from engaging in a pattern or practice of extending higher-priced mortgage loans based on the collateral without regard to repayment ability. Thus, if a creditor steered borrowers into higher-priced mortgage loans that the borrower may not have the ability to repay—or accepted loans from brokers that had done so—the creditor would risk violating proposed § 226.35(b)(1).

X. Advertising

The Board proposes to amend the advertising rules for open-end home-equity plans under § 226.16, and for closed-end credit under § 226.24 to address advertisements for home-secured loans. For open-end home-equity plan advertisements, the two most significant changes relate to the clear and conspicuous standard and the advertisement of introductory terms. For advertisements for closed-end credit secured by a dwelling, the three most significant changes relate to strengthening the clear and conspicuous standard for advertising disclosures, regulating the disclosure of rates and payments in advertisements to ensure that low introductory or ''teaser'' rates or payments are not given undue emphasis, and prohibiting certain acts or practices in advertisements as provided under Section 129(l)(2) of TILA.

[70] *See, e.g.*, Interagency Credit Risk Management Guidance for Home Equity Lending, Fed. Reserve Bd. SR Letter 05–11 (May 16, 2005); Addendum to Credit Risk Management Guidance for Home Equity Lending, Fed. Reserve Bd. SR Letter 06–15 app. 3 (Nov. 26, 2006).

[71] Consumer Bankers Ass'n, *2006 Home Equity Loan Study* (June 30, 2006) (reporting that about 10 percent of HELOCs were originated through a broker channel recently).

A. Advertising Rules for Open-end Home-equity Plans—§ 226.16

Overview

The Board is proposing to amend the open-end home-equity plan advertising rules in § 226.16. The two most significant changes relate to the clear and conspicuous standard and the advertisement of introductory terms in home-equity plans. Each of these proposed changes is summarized below.

First, the Board is proposing to revise the clear and conspicuous standard for home-equity plan advertisements, consistent with the approach taken in the advertising rules for consumer leases under Regulation M. *See* 12 CFR 213.7(b). New commentary provisions would clarify how the clear and conspicuous standard applies to advertisements of home-equity plans with introductory rates or payments, and to Internet, television, and oral advertisements of home-equity plans. The proposal would also allow alternative disclosures for television and radio advertisements for home-equity plans by revising the Board's earlier proposal for open-end plans that are not home-secured to apply to home-equity plans as well. *See* 12 CFR 226.16(f) *and* 72 FR 32948, 33064 (June 14, 2007).

Second, the Board is proposing to amend the regulation and commentary to ensure that advertisements adequately disclose not only introductory plan terms, but also the rates and payments that will apply over the term of the loan. The proposed changes are modeled after proposed amendments to the advertising rules for open-end plans that are not home-secured. *See* 72 FR 32948, 33064 (June 14, 2007).

The Board is also proposing changes to implement provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 which requires disclosure of the tax implications of certain home-equity plans. *See* Pub. L. No. 109–8, 119 Stat. 23. Other technical and conforming changes are also proposed.

The Board is not proposing to extend to home-equity plan advertisements the prohibitions it proposes to apply to advertisements for closed-end credit secured by a dwelling. As discussed below in connection with its proposed changes to § 226.24, the Board is proposing to prohibit certain acts or practices connected with advertisements for closed-end mortgage credit under TILA § 129(l)(2). *See* discussion of § 226.24(i) below. Based on its review of advertising copy and outreach efforts, the Board has not identified similar misleading acts or practices in advertisements for home-equity plans. The Board seeks comment, however, on whether it should extend any or all of the prohibitions contained in the proposed § 226.24(i) to home-equity plans, or whether there are other acts or practices associated with advertisements for home-equity plans that should be prohibited.

Current Statute and Regulation

TILA Section 147, implemented by the Board in § 226.16(d), governs advertisements of open-end home-equity plans secured by the consumer's principal dwelling. 15 U.S.C. 1665b. The statute applies to the advertisement itself, and therefore, the statutory and regulatory requirements apply to any person advertising an open-end credit plan, whether or not they meet the definition of creditor. *See* comment 2(a)(2)–2. Under the statute, if an open-end credit advertisement sets forth, affirmatively or negatively, any of the specific terms of the plan, including any required periodic payment amount, then the advertisement must also clearly and conspicuously state: (1) Any loan fee the amount of which is determined as a percentage of the credit limit and an estimate of the aggregate amount of other fees for opening the account; (2) in any case in which periodic rates may be used to compute the finance charge, the periodic rates expressed as an annual percentage rate; (3) the highest annual percentage rate which may be imposed under the plan; and (4) any other information the Board may by regulation require.

The specific terms of an open-end plan that ''trigger'' additional disclosures, which are commonly known as ''triggering terms,'' are the payment terms of the plan, or finance charges and other charges required to be disclosed under §§ 226.6(a) and 226.6(b). If an advertisement for a home-equity plan states a triggering term, the regulation requires that the advertisement also state the terms required by the statute. *See* 12 CFR 226.16(d)(1); *see also* comments 16(d)–1, and 16(d)–2.

Discussion

Clear and conspicuous standard. The Board is proposing to add comments 16–4 to 16–7 to clarify how the clear and conspicuous standard applies to advertisements for home-equity plans.

Currently, comment 16–1 explains that advertisements for open-end credit are subject to a clear and conspicuous standard set out in § 226.5(a)(1). The Board is not prescribing specific rules regarding the format of advertisements. However, proposed comment 16–4 would elaborate on the requirement that certain disclosures about introductory rates or payments in advertisements for home-equity plans be prominent and in close proximity to the triggering terms in order to satisfy the clear and conspicuous standard when introductory rates or payments are advertised and the disclosure requirements of proposed § 226.16(d)(6) apply. The disclosures would be deemed to meet this requirement if they appear immediately next to or directly above or below the trigger terms, without any intervening text or graphical displays. Terms required to be disclosed with equal prominence to the introductory rate or payment would be deemed to meet this requirement if they appear in the same type size as the trigger terms. A more detailed discussion of the proposed requirements for introductory rates or payments is found below.

The equal prominence and close proximity requirements of proposed § 226.16(d)(6) would apply to all visual text advertisements. However, comment 16–4 states that electronic advertisements that disclose introductory rates or payments in a manner that complies with the Board's recently amended rule for electronic advertisements under § 226.16(c) would be deemed to satisfy the clear and conspicuous standard. *See* 72 FR 63462 (Nov. 9, 2007). Under the rule, if an electronic advertisement provides the required disclosures in a table or schedule, any statement of triggering terms elsewhere in the advertisement must clearly direct the consumer to the location of the table or schedule. For example, a triggering term in an advertisement on an Internet Web site may be accompanied by a link that directly takes the consumer to the additional information. *See* comment 16(c)(1)–2.

An electronic advertisement may require consumers to scroll down a page, or click a link, to access important rate or payment information under the current rule. For example, an electronic advertisement may state a low introductory payment and require the consumer to click a link to find out that the payment applies for only two years and the payments that will apply after that. Using links in this manner may permit Internet advertisements to continue to emphasize low, introductory ''teaser'' rates or payments, while de-emphasizing rates or payments that apply for the term of a plan, as sometimes occurs with the use of footnotes. However, the Board recognizes that electronic advertisements may be displayed on

devices with small screens, such as on Internet-enabled cellphones or personal digital assistants, that might necessitate scrolling in order to view additional information. The Board seeks comment on whether it should amend the rules for electronic advertisements for home-equity plans to require that all information about rates or payments that apply for the term of the plan be stated in close proximity to introductory rates or payments in a manner that does not require the consumer to click a link to access the information. The Board also solicits comment on the costs and practical limitations, if any, of imposing this close proximity requirement on electronic advertisements.

The Board is also proposing to interpret the clear and conspicuous standards for Internet, television, and oral advertisements of home-equity plans. Proposed comment 16–5 explains that disclosures in the context of visual text advertisements on the Internet must not be obscured by techniques such as graphical displays, shading, coloration, or other devices, and must comply with all other requirements for clear and conspicuous disclosures under § 226.16(d). Proposed comment 16–6 likewise explains that textual disclosures in television advertisements must not be obscured by techniques such as graphical displays, shading, coloration, or other devices, must be displayed in a manner that allows the consumer to read the information, and must comply with all other requirements for clear and conspicuous disclosures under § 226.16(d). Proposed comment 16–7 would explain that oral advertisements, such as by radio or television, must provide disclosures at a speed and volume sufficient for a consumer to hear and comprehend them. In this context, the word ''comprehend'' means that the disclosures must be intelligible to consumers, not that advertisers must ensure that consumers understand the meaning of the disclosures. The Board is also proposing to allow the use of a toll-free telephone number as an alternative to certain oral disclosures in television or radio advertisements.

226.16(d)(2)—Discounted and Premium Rates

If an advertisement for a variable-rate home-equity plan states an initial annual percentage rate that is not based on the index and margin used to make later rate adjustments, the advertisement must also state the period of time the initial rate will be in effect, and a reasonably current annual percentage rate that would have been in effect using the index and margin. *See* 12 CFR 226.16(d)(2). The Board proposes to revise this section to require that the triggered disclosures be stated with equal prominence and in close proximity to the statement of the initial APR. The Board believes that this will enhance consumers' understanding of the cost of credit for the home-equity plan being advertised.

Proposed comment 16(d)–6 would provide safe harbors for what constitutes a ''reasonably current index and margin'' as used in § 226.16(d)(2) as well as § 226.16(d)(6). Under the proposed comment, the time period during which an index and margin would be considered reasonably current would depend on the medium in which the advertisement was distributed. For direct mail advertisements, a reasonably current index and margin would be one that was in effect within 60 days before mailing. For advertisements in electronic form, a reasonably current index and margin would be one that was in effect within 30 days before the advertisement was sent to a consumer's e-mail address, or for advertisements made on an Internet Web site, when viewed by the public. For printed advertisements made available to the general public, a reasonably current index and margin would be one that was in effect within 30 days before printing.

226.16(d)(3)—Balloon Payment

If an advertisement for a home-equity plan contains a statement about any minimum periodic payment, the advertisement must also state, if applicable, that a balloon payment may result. *See* 12 CFR 226.16(d)(3). The Board proposes to revise this section to clarify that only statements about the amount of any minimum periodic payment trigger the required disclosure, and to require that the disclosure of a balloon payment be equally prominent and in close proximity to the statement of a minimum periodic payment. Consistent with comment 5b(d)(5)(ii)–3, the Board proposes to clarify that the disclosure is triggered when an advertisement contains a statement of any minimum periodic payment and a balloon payment may result if only minimum periodic payments are made, even if a balloon payment is uncertain or unlikely. Additionally, the Board proposes to clarify that a balloon payment results if paying the minimum periodic payments would not fully amortize the outstanding balance by a specified date or time, and the consumer must repay the entire outstanding balance at such time.

Current comment 16(d)–7 states that an advertisement for a plan where a balloon payment will occur when only minimum payments are made must also state the fact that a balloon payment will result (not merely that a balloon payment ''may'' result). The Board proposes to incorporate the language from comment 16(d)–7 into the text of § 226.16(d)(3) with technical revisions. The comment would be revised and renumbered as comment 16(d)–9. The required disclosures regarding balloon payments must be stated with equal prominence and in close proximity to the minimum periodic payment. The Board believes that this will enhance consumers' ability to notice and understand the potential financial impact of making only minimum payments.

226.16(d)(4)—Tax Implications

Section 1302 of the Bankruptcy Act amends TILA Section 147(b) to require additional disclosures for advertisements that are disseminated in paper form to the public or through the Internet, relating to an extension of credit secured by a consumer's principal dwelling that may exceed the fair market value of the dwelling. Such advertisements must include a statement that the interest on the portion of the credit extension that is greater than the fair market value of the dwelling is not tax deductible for Federal income tax purposes. 15 U.S.C. 1665b(b). The statute also requires a statement that the consumer should consult a tax adviser for further information on the deductibility of the interest.

The Bankruptcy Act also requires that disclosures be provided at the time of application in cases where the extension of credit may exceed the fair market value of the dwelling. *See* 15 U.S.C. 1637a(a)(13). The Board intends to implement the application disclosure portion of the Bankruptcy Act during its forthcoming review of closed-end and HELOC disclosures under TILA. However, the Board requested comment on the implementation of both the advertising and application disclosures under this provision of the Bankruptcy Act for open-end credit in its October 17, 2005, ANPR. 70 FR 60235, 60244 (Oct. 17, 2005). A majority of comments on this issue addressed only the application disclosure requirement, but some commenters specifically addressed the advertising disclosure requirement. One industry commenter suggested that the advertising disclosure requirement apply only in cases where the advertised product allows for the credit to exceed the fair market value of the dwelling. Other industry commenters suggested that the

requirement apply only to advertisements for products that are intended to exceed the fair market value of the dwelling.

The Board proposes to revise § 226.16(d)(4) and comment 16(d)–3 to implement TILA Section 147(b). The Board's proposal clarifies that the new requirements apply to advertisements for home-equity plans where the advertised extension of credit may, by its terms, exceed the fair market value of the dwelling. The Board seeks comment on whether the new requirements should only apply to advertisements that state or imply that the creditor provides extensions of credit greater than the fair market value of the dwelling.

226.16(d)(6)—Introductory Rates and Payments

The Board is proposing to add § 226.16(d)(6) to address the advertisement of introductory rates and payments in advertisements for home-equity plans. The proposed rule provides that if an advertisement for a home-equity plan states an introductory rate or payment, the advertisement must use the term ''introductory'' or ''intro'' in immediate proximity to each mention of the introductory rate or payment. The proposed rule also provides that such advertisements must disclose the following information in a clear and conspicuous manner with each listing of the introductory rate or payment: the period of time during which the introductory rate or introductory payment will apply; in the case of an introductory rate, any annual percentage rate that will apply under the plan; and, in the case of an introductory payment, the amount and time periods of any payments that will apply under the plan. In variable-rate transactions, payments that will be determined based on application of an index and margin to an assumed balance shall be disclosed based on a reasonably current index and margin. Although introductory rates are addressed, in part, by § 226.16(d)(2), which deals with the advertisement of discounted and premium rates, § 226.16(d)(6) is broader because it is not limited to initial rates, but applies to any advertised rate that applies for a limited period of time.

Proposed § 226.16(d)(6) is similar to the approach taken by the Board with regard to the advertisement of introductory rates for open-end (not home-secured) plans in the June 2007 proposal to amend the Regulation Z open-end advertising rules. *See* 72 FR 32948, 33064 (June 14, 2007). However, the June 2007 proposal would only apply to the advertisement of introductory rates, while this proposal would apply to the advertisement of both introductory rates and payments.

226.16(d)(6)(i)—Definitions

The Board proposes to define the terms ''introductory rate,'' ''introductory payment,'' and ''introductory period'' in § 226.16(d)(6)(i). In a variable-rate plan, the term ''introductory rate'' means any annual percentage rate applicable to a home-equity plan that is not based on the index and margin that will be used to make rate adjustments under the plan, if that rate is less than a reasonably current annual percentage rate that would be in effect based on the index and margin that will be used to make rate adjustments under the plan. The term ''introductory payment'' means, in the case of a variable-rate plan, the amount of any payment applicable to a home-equity plan for an introductory period that is not derived from the index and margin that will be used to determine the amount of any other payments under the plan and, given an assumed balance, is less than any other payment that will be in effect under the plan based on a reasonably current application of the index and margin that will be used to determine the amount of such payments. For a non-variable-rate plan, the term ''introductory payment'' means the amount of any payment applicable to a home-equity plan for an introductory period if that payment is less than the amount of any other payments that will be in effect under the plan given an assumed balance. The term ''introductory period'' means a period of time, less than the full term of the loan, that the introductory rate or payment may be applicable.

Proposed comment 16(d)–5.i clarifies how the concepts of introductory rates and introductory payments apply in the context of advertisements for variable-rate plans. Specifically, the proposed comment provides that if the advertised annual percentage rate or the advertised payment is based on the index and margin that will be used to make rate or payment adjustments over the term of the loan, then there is no introductory rate or introductory payment. On the other hand, if the advertised annual percentage rate, or the advertised payment, is not based on the index and margin that will be used to make rate or payment adjustments, and a reasonably current application of the index and margin would result in a higher annual percentage rate or, given an assumed balance, a higher payment, then there is an introductory rate or introductory payment. The proposed revisions generally assume that a single index and margin will be used to make rate or payment adjustments under the plan. The Board solicits comment on whether and to what extent multiple indexes and margins are used in home-equity plans and whether additional or different rules are needed for such products.

Proposed comment 16(d)–5.v clarifies how the concept of introductory payments applies in the context of advertisements for non-variable-rate plans. Specifically, the proposed comment provides that if the advertised payment is calculated in the same way as other payments under the plan based on an assumed balance, the fact that the payment could increase solely if the consumer made an additional draw does not make the payment an introductory payment. For example, if a payment of $500 results from an assumed $10,000 draw, and the payment would increase to $1000 if the consumer made an additional $10,000 draw, the payment is not an introductory payment.

226.16(d)(6)(ii)—Stating the Term ''Introductory''

Proposed § 226.16(d)(6)(ii) would require creditors to state either the term ''introductory'' or its commonly-understood abbreviation ''intro'' in immediate proximity to each listing of the introductory rate or payment in an advertisement for a home-equity plan. Proposed comment 16(d)–5.ii clarifies that placing the word ''introductory'' or ''intro'' within the same sentence as the introductory rate or introductory payment satisfies the immediately proximate standard.

226.16(d)(6)(iii)—Stating the Introductory Period and Post-Introductory Rate or Payments

Proposed § 226.16(d)(6)(iii) provides that if an advertisement states an introductory rate or introductory payment, it must also clearly and conspicuously disclose, with equal prominence and in close proximity to the introductory rate or payment, the following, as applicable: the period of time during which the introductory rate or introductory payment will apply; in the case of an introductory rate, any annual percentage rate that will apply under the plan; and, in the case of an introductory payment, the amount and time periods of any payments that will apply under the plan. In variable-rate transactions, payments that will be determined based on application of an index and margin to an assumed balance shall be disclosed based on a reasonably current index and margin.

Proposed comment 16(d)–5.iii provides safe harbors for satisfying the closely proximate or equally prominent

requirements of proposed § 226.16(d)(6)(iii). Specifically, the required disclosures will be deemed to be closely proximate to the introductory rate or payment if they are in the same paragraph as the introductory rate or payment. Information disclosed in a footnote will not be deemed to be closely proximate to the introductory rate or payment. Consumer testing of account-opening and other disclosures undertaken in conjunction with the Board's open-end Regulation Z proposal suggests that placing information in a footnote makes it much less likely that the consumer will notice it. The required disclosures will be deemed equally prominent with the introductory rate or payment if they are in the same type size as the introductory rate or payment.

Proposed comment 16(d)–5.iv clarifies that the requirement to disclose the amount and time periods of any payments that will apply under the plan may require the disclosure of several payment amounts, including any balloon payments. The comment provides an example of a home-equity plan with several payment amounts over the repayment period to illustrate the disclosure requirements. Proposed comment 16(d)–6, which is discussed above, would provide safe harbor definitions for the phrase ''reasonably current index and margin.''

226.16(d)(6)(iv)—Envelope Excluded

Proposed § 226.16(d)(6)(iv) provides that the requirements of § 226.16(d)(6)(iii) do not apply to envelopes, or to banner advertisements and pop-up advertisements that are linked to an electronic application or solicitation provided electronically. In the Board's view, because banner advertisements and pop-up advertisements are used to direct consumers to more detailed advertisements, they are similar to envelopes in the direct mail context.

226.16(f)—Alternative Disclosures—Television or Radio Advertisements

The Board is proposing to expand § 226.16(f) to allow for alternative disclosures of the information required for home-equity plans under § 226.16(d)(1), where applicable, consistent with its proposal for credit cards and other open-end plans. *See* proposed § 226.16(f) *and* 72 FR 32948, 33064 (June 14, 2007).

The Board's proposed revision follows the general format of the Board's earlier proposal for alternative disclosures for oral television and radio advertisements. If a triggering term is stated in the advertisement, one option would be to state each of the disclosures required by current §§ 226.16(b)(1) and (d)(1) at a speed and volume sufficient for a consumer to hear and comprehend them. Another option would be for the advertisement to state orally the APR applicable to the home-equity plan, and the fact that the rate may be increased after consummation, and provide a toll-free telephone number that the consumer may call to receive more information. Given the space and time constraints on television and radio advertisements, the required disclosures may go unnoticed by consumers or be difficult for them to retain. Thus, providing an alternative means of disclosure may be more effective in many cases given the nature of the media.

This approach is also similar to the approach taken in the advertising rules for consumer leases under Regulation M, which also allows the use of toll-free numbers in television and radio advertisements. *See* 12 CFR 213.7(f)(1)(ii).

B. Advertising Rules for Closed-end Credit—§ 226.24

Overview

The Board is proposing to amend the closed-end credit advertising rules in § 226.24 to address advertisements for home-secured loans. The three most significant changes relate to strengthening the clear and conspicuous standard for advertising disclosures, regulating the disclosure of rates and payments in advertisements to ensure that low introductory or ''teaser'' rates or payments are not given undue emphasis, and prohibiting certain acts or practices in advertisements as provided under Section 129(l)(2) of TILA, 15 U.S.C. 1639(l)(2). Each of these proposed changes is summarized below.

First, the Board is proposing to add a provision setting forth the clear and conspicuous standard for all closed-end advertisements and a number of new commentary provisions applicable to advertisements for home-secured loans. The regulation would be revised to include a clear and conspicuous standard for advertising disclosures, consistent with the approach taken in the advertising rules for Regulation M. *See* 12 CFR 213.7(b). New commentary provisions would be added to clarify how the clear and conspicuous standard applies to rates or payments in advertisements for home-secured loans, and to Internet, television, and oral advertisements of home-secured loans. The proposal would also add a provision to allow alternative disclosures for television and radio advertisements that is modeled after a proposed revision to the advertising rules for open-end (not home-secured) plans. *See* 72 FR 32948, 33064 (June 14, 2007).

Second, the Board is proposing to amend the regulation and commentary to address the advertisement of rates and payments for home-secured loans. The proposed revisions are designed to ensure that advertisements adequately disclose all rates or payments that will apply over the term of the loan and the time periods for which those rates or payments will apply. Many advertisements for home-secured loans place undue emphasis on low, introductory ''teaser'' rates or payments that will apply for a limited period of time. Such advertisements do not give consumers accurate or balanced information about the costs or terms of the products offered.

The proposed revisions would also prohibit advertisements from disclosing an interest rate lower than the rate at which interest is accruing. Instead, the only rates that could be included in advertisements for home-secured loans are the APR and one or more simple annual rates of interest. Many advertisements for home-secured loans promote very low rates that do not appear to be the rates at which interest is accruing. The advertisement of interest rates lower than the rate at which interest is accruing is likely confusing for consumers. Taken together, the Board believes that the proposed changes regarding the disclosure of rates and payments in advertisements for home-secured loans will enhance the accuracy of advertising disclosures and benefit consumers.

Third, pursuant to TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), the Board is proposing to prohibit seven specific acts or practices in connection with advertisements for home-secured loans that the Board finds to be unfair, deceptive, associated with abusive lending practices, or otherwise not in the interest of the borrower.

Bankruptcy Act changes. The Board is also proposing several changes to clarify certain provisions of the closed-end advertising rules, including the scope of the certain triggering terms, and to implement provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 requiring disclosure of the tax implications of home-secured loans. *See* Pub. L. No. 109–8, 119 Stat. 23. Technical and conforming changes to the closed-end advertising rules are also proposed.

Outreach. The Board's staff conducted extensive research and outreach in connection with developing the

proposed revisions to the closed-end advertising rules. Board staff collected and reviewed numerous examples of advertising copy for home-secured loans. Board staff also consulted with representatives of consumer and community groups and Federal Trade Commission staff to identify areas where the advertising disclosures could be improved, as well as to identify acts or practices connected with advertisements for home-secured loans that should be prohibited. This research and outreach indicated that many advertisements prominently disclose terms that apply to home-secured loans for a limited period of time, such as low introductory ''teaser'' rates or payments, while disclosing with much less prominence, often in a footnote, the rates or payments that apply over the full term of the loan. Board staff also identified through this research and outreach effort particular advertising acts or practices that can mislead consumers.

Current Statute and Regulation

TILA Section 144, implemented by the Board in § 226.24, governs advertisements of credit other than open-end plans. 15 U.S.C. 1664. TILA Section 144 thus applies to advertisements of closed-end credit, including advertisements for closed-end credit secured by a dwelling (also referred to as ''home-secured loans''). The statute applies to the advertisement itself, and therefore, the statutory and regulatory requirements apply to any person advertising closed-end credit, whether or not such person meets the definition of creditor. *See* comment 2(a)(2)–2. Under the statute, if an advertisement states the rate of a finance charge, the advertisement must state the rate of that charge as an APR. In addition, closed-end credit advertisements that contain certain terms must also include additional disclosures. The specific terms of closed-end credit that ''trigger'' additional disclosures, which are commonly known as ''triggering terms,'' are (1) the amount of the downpayment, if any, (2) the amount of any installment payment, (3) the dollar amount of any finance charge, and (4) the number of installments or the period of repayment. If an advertisement for closed-end credit states a triggering term, then the advertisement must also state any downpayment, the terms of repayment, and the rate of the finance charged expressed as an APR. *See* 12 CFR 226.24(b)–(c); *see also* comments 24(b)–(c) (as redesignated to proposed §§ 226.24(c)–(d) and comments 24(c)–(d)).

TILA Section 105(a) authorizes the Board to adopt regulations to ensure meaningful disclosure of credit terms so that consumers will be able to compare available credit terms and avoid the uninformed use of credit. 15 U.S.C. 1604(a). TILA Section 122 authorizes the Board to require that information, including the information required under Section 144, be disclosed in a clear and conspicuous manner. 15 U.S.C. 1632. TILA Section 129(l)(2) authorizes the Board to prohibit acts or practices in connection with mortgage loans that the Board finds to be unfair or deceptive. TILA Section 129(l)(2) also authorizes the Board to prohibit acts or practices in connection with the refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower. 15 U.S.C. 1639(l)(2).

226.24(b)—Clear and Conspicuous Standard

The Board is proposing to add a clear and conspicuous standard in § 226.24(b) that would apply to all closed-end advertising. This provision would supplement, rather than replace, the clear and conspicuous standard that applies to all closed-end credit disclosures under Subpart C of Regulation Z and that requires all disclosures be in a reasonably understandable form. *See* 12 CFR 226.17(a)(1); comment 17(a)(1)–1. The new provision provides a framework for clarifying how the clear and conspicuous standard applies to advertisements that are not in writing or in a form that the consumer may keep, or that emphasize introductory rates or payments.

Currently, comment 24–1 explains that advertisements for closed-end credit are subject to a clear and conspicuous standard based on § 226.17(a)(1). The existing comment would be renumbered as comment 24(b)–1 and revised to reference the proposed format requirements for advertisements of rates or payments for home-secured loans. The Board is not prescribing specific rules regarding the format of advertising disclosures generally. However, proposed comment 24(b)–2 would elaborate on the requirement that certain disclosures about rates or payments in advertisements for home-secured loans be prominent and in close proximity to other information about rates or payments in the advertisement in order to satisfy the clear and conspicuous standard and the disclosure requirements of proposed § 226.24(f). Terms required to be disclosed in close proximity to other rate or payment information would be deemed to meet this requirement if they appear immediately next to or directly above or below the trigger terms, without any intervening text or graphical displays. Terms required to be disclosed with equal prominence to other rate or payment information would be deemed to meet this requirement if they appear in the same type size as other rates or payments. A more detailed discussion of the proposed requirements for disclosing rates or payments is found below.

The equal prominence and close proximity requirements of proposed § 226.24(f) would apply to all visual text advertisements. However, comment 24(b)–2 states that electronic advertisements that disclose rates or payments in a manner that complies with the Board's recently amended rule for electronic advertisements under current § 226.24(d) would be deemed to satisfy the clear and conspicuous standard. *See* 72 FR 63462 (Nov. 9, 2007). Under the rule, if an electronic advertisement provides the required disclosures in a table or schedule, any statement of triggering terms elsewhere in the advertisement must clearly direct the consumer to the location of the table or schedule. For example, a triggering term in an advertisement on an Internet Web site may be accompanied by a link that directly takes the consumer to the additional information. *See* comment 24(d)–4.

The Board recognizes that electronic advertisements may be displayed on devices with small screens that might necessitate scrolling to view additional information. The Board seeks comment, however, on whether it should amend the rules for electronic advertisements for home-secured loans to require that all information about rates or payments that apply for the term of the loan be stated in close proximity to other rates or payments in a manner that does not require the consumer to click a link to access the information. The Board also solicits comment on the costs and practical limitations, if any, of imposing this close proximity requirement on electronic advertisements.

The Board is also proposing to interpret the clear and conspicuous standards for Internet, television, and oral advertisements of home-secured loans. Proposed comment 24(b)–3 explains that disclosures in the context of visual text advertisements on the Internet must not be obscured by techniques such as graphical displays, shading, coloration, or other devices, and must comply with all other requirements for clear and conspicuous

disclosures under § 226.24. Proposed comment 24(b)–4 likewise explains that visual text advertisements on television must not be obscured by techniques such as graphical displays, shading, coloration, or other devices, must be displayed in a manner that allows a consumer to read the information required to be disclosed, and must comply with all other requirements for clear and conspicuous disclosures under § 226.24. Proposed comment 24(b)–5 would explain that oral advertisements, such as by radio or television, must provide the disclosures at a speed and volume sufficient for a consumer to hear and comprehend them. In this context, the word ''comprehend'' means that the disclosures be intelligible to consumers, not that advertisers must ensure that consumers understand the meaning of all of the disclosures. Proposed § 226.24(g) provides an alternative method of disclosure for television or radio advertisements when trigger terms are stated orally and is discussed more fully below.

226.24(c)—Advertisement of Rate of Finance Charge

Disclosure of simple annual rate or periodic rate. If an advertisement states a rate of finance charge, it shall state the rate as an APR. *See* 12 CFR 226.24(b) (as redesignated to proposed § 226.24(c)). An advertisement may also state, in conjunction with and not more conspicuously than the APR, a simple annual rate or periodic rate that is applied to an unpaid balance.

The Board proposes to renumber § 226.24(b) as § 226.24(c), and revise it. The revised rule would provide that advertisements for home-secured loans shall not state any rate other than an APR, except that a simple annual rate that is applied to an unpaid balance may be stated in conjunction with, but not more conspicuously than, the APR. Advertisement of a periodic rate, other than the simple annual rate, or any other rates would no longer be permitted in connection with home-secured loans.

Comment 24(b)–2 would be renumbered as comment 24(c)–2 and revised to clarify that a simple annual rate or periodic rate is the rate at which interest is accruing. A rate lower than the rate at which interest is accruing, such as an effective rate, payment rate, or qualifying rate, is not a simple annual rate or periodic rate. The example in renumbered comment 24(c)–2 also would be revised to reference proposed § 226.24(f), which contains requirements regarding the disclosure of rates and payments in advertisements for home-secured loans.

Buydowns. Comment 24(b)–3, which addresses ''buydowns,'' would be renumbered as comment 24(c)–3 and revised. A buydown is where a seller or creditor offers a reduced interest rate and reduced payments to a consumer for a limited period of time. Comment 24(c)–3 allows the seller or creditor, in the case of a buydown, to advertise the reduced simple interest rate, the limited term to which the reduced rate applies, and the simple interest rate applicable to the balance of the term. The advertisement may show the effect of the buydown agreement on the payment schedule for the buydown period. The Board proposes to revise the comment to explain that additional disclosures would be required when an advertisement includes information showing the effect of the buydown agreement on the payment schedule. Such advertisements would have to provide the disclosures required by current § 226.24(c)(2) because showing the effect of the buydown agreement on the payment schedule is a statement about the amount of any payment, and thus is a triggering term. *See* 12 CFR 226.24(c)(1)(iii). In these circumstances, the additional disclosures are necessary for consumers to understand the costs of the loan and the terms of repayment. Consistent with these changes, the examples of statements about buydowns that an advertisement may make without triggering additional disclosures would be removed.

Effective rates. The Board is proposing to delete current comment 24(b)–4. The current comment allows the advertisement of three rates: the APR; the rate at which interest is accruing; and an interest rate lower than the rate at which interest is accruing, which may be referred to as an effective rate, payment rate, or qualifying rate. The comment also contains an example of how to disclose the three rates.

The Board is proposing to delete this comment for the reasons stated below. First, the disclosure of three rates is unnecessarily confusing for consumers and the disclosure of an interest rate lower than the rate at which interest is accruing does not provide meaningful information to consumers about the cost of credit. Second, when the effective rates comment was adopted in 1982, the Board noted that the comment was designed ''to address the advertisement of special financing involving 'effective rates,' 'payment rates,' or 'qualifying rates.''' *See* 47 FR 41338, 41342 (Sept. 20, 1982). At that time, when interest rates were quite high, these terms were used in connection with graduated-payment mortgages. Today, however, some advertisers appear to rely on this comment when advertising rates for a variety of home-secured loans, such as negative amortization loans and option ARMs. In these circumstances, the advertisement of rates lower than the rate at which interest is accruing for these products is not helpful to consumers, particularly consumers who may not fully understand how these non-traditional home-secured loans work.

Discounted variable-rate transactions. Comment 24(b)–5 would be renumbered as comment 24(c)–4 and revised to explain that an advertisement for a discounted variable-rate transaction which advertises a reduced or discounted simple annual rate must show with equal prominence and in close proximity to that rate, the limited term to which the simple annual rate applies and the annual percentage rate that will apply after the term of the initial rate expires.

The comment would also be revised to explain that additional disclosures would be required when an advertisement includes information showing the effect of the discount on the payment schedule. Such advertisements would have to provide the disclosures required by current § 226.24(c)(2). Showing the effect of the discount on the payment schedule is a statement about the number of payments or the period of repayment, and thus is a triggering term. *See* 12 CFR 226.24(c)(1)(ii). In these circumstances, the additional disclosures are necessary for consumers to understand the costs of the loan and the terms of repayment. Consistent with these changes, the examples of statements about discounted variable-rate transactions that an advertisement may make without triggering additional disclosures would be removed.

226.24(d)—Advertisement of Terms That Require Additional Disclosures

Required disclosures. The Board proposes to renumber § 226.24(c) as § 226.24(d) and revise it. The proposed rule would clarify the meaning of the ''terms of repayment'' required to be disclosed. Specifically, the terms of repayment must reflect ''the repayment obligations over the full term of the loan, including any balloon payment,'' not just the repayment terms that will apply for a limited period of time. This proposed revision is consistent with other proposed changes and is designed to ensure that advertisements for closed-end credit, especially home-secured loans, adequately disclose the terms that

will apply over the full term of the loan, not just for a limited period of time.

Consistent with these proposed changes, comment 24(c)(2)–2 would be renumbered as comment 24(d)(2)–2 and revised. Commentary regarding advertisement of loans that have a graduated-payment feature would be removed from comment 24(d)(2)–2.

In advertisements for home-secured loans where payments may vary because of the inclusion of mortgage insurance premiums, the comment would explain that the advertisement may state the number and timing of payments, the amounts of the largest and smallest of those payments, and the fact that other payments will vary between those amounts.

In advertisements for home-secured loans with one series of low monthly payments followed by another series of higher monthly payments, the comment would explain that the advertisement may state the number and time period of each series of payments and the amounts of each of those payments. However, the amount of the series of higher payments would have to be based on the assumption that the consumer makes the lower series of payments for the maximum allowable period of time. For example, if a consumer has the option of making interest-only payments for two years and an advertisement states the amount of the interest-only payment, the advertisement must state the amount of the series of higher payments based on the assumption that the consumer makes the interest-only payments for the full two years. The Board believes that without these disclosures consumers may not fully understand the cost of the loan or the payment terms that may result once the higher payments take effect.

The proposed revisions to renumbered comment 24(d)(2)–2 would apply to all closed-end advertisements. The Board believes that the terms of repayment for any closed-end credit product should be disclosed for the full term of the loan, not just for a limited period of time. The Board also does not believe that this proposed change will significantly impact advertising practices for closed-end credit products such as auto loans and installment loans that ordinarily have shorter terms than home-secured loans.

New comment 24(d)(2)–3 would be added to address the disclosure of balloon payments as part of the repayment terms. The proposed comment notes that in some transactions, a balloon payment will occur when the consumer only makes the minimum payments specified in an advertisement. A balloon payment results if paying the minimum payments does not fully amortize the outstanding balance by a specified date or time, usually the end of the term of the loan, and the consumer must repay the entire outstanding balance at such time. The proposed comment explains that if a balloon payment will occur if the consumer only makes the minimum payments specified in an advertisement, the advertisement must state with equal prominence and in close proximity to the minimum payment statement the amount and timing of the balloon payment that will result if the consumer makes only the minimum payments for the maximum period of time that the consumer is permitted to make such minimum payments. The Board believes that disclosure of the balloon payment in advertisements that promote such minimum payments is necessary to inform consumers about the repayment terms that will apply over the full term of the loan.

Current comments 24(c)(2)–3 and 24(c)(2)–4 would be renumbered as comments 24(d)(2)–4 and 24(d)(2)–5 without substantive change.

226.24(e)—Catalogs or Other Multiple-Page Advertisements; Electronic Advertisements

The Board is proposing to renumber § 226.24(d) as § 226.24(e) and make technical changes to reflect the renumbering of certain sections of the regulation and commentary.

226.24(f)—Disclosure of Rates and Payments in Advertisements for Credit Secured by a Dwelling

The Board is proposing to add a new subsection (f) to § 226.24 to address the disclosure of rates and payments in advertisements for home-secured loans. The primary purpose of these provisions is to ensure that advertisements do not place undue emphasis on low introductory ''teaser'' rates or payments, but adequately disclose the rates and payments that will apply over the term of the loan. The specific provisions of proposed subsection (f) are discussed below.

226.24(f)(1)—Scope

Proposed § 226.24(f)(1) provides that the new section applies to any advertisement for credit secured by a dwelling, other than television or radio advertisements, including promotional materials accompanying applications. The Board does not believe it is feasible to apply the requirements of this section, notably the close proximity and prominence requirements, to oral advertisements. However, the Board requests comment on whether these or different standards should be applied to oral advertisements for home-secured loans.

226.24(f)(2)—Disclosure of Rates

Proposed § 226.24(f)(2) addresses the disclosure of rates. Under the proposed rule, if an advertisement for credit secured by a dwelling states a simple annual rate of interest and more than one simple annual rate of interest will apply over the term of the advertised loan, the advertisement must disclose the following information in a clear and conspicuous manner: (a) Each simple annual rate of interest that will apply. In variable-rate transactions, a rate determined by an index and margin must be disclosed based on a reasonably current index and margin; (b) the period of time during which each simple annual rate of interest will apply; and (c) the annual percentage rate for the loan. If the rate is variable, the annual percentage rate must comply with the accuracy standards in §§ 226.17(c) and 226.22.

Proposed comment 24(f)–4 would specifically address how this requirement applies in the context of advertisements for variable-rate transactions. For such transactions, if the simple annual rate that applies at consummation is based on the index and margin that will be used to make subsequent rate adjustments over the term of the loan, then there is only one simple annual rate and the requirements of § 226.24(f)(2) do not apply. If, however, the simple annual rate that applies at consummation is not based on the index and margin that will be used to make subsequent rate adjustments over the term of the loan, then there is more than one simple annual rate and the requirements of § 226.24(f)(2) apply. The proposed revisions generally assume that a single index and margin will be used to make rate or payment adjustments under the loan. The Board solicits comment on whether and to what extent multiple indexes and margins are used in home-secured loans and whether additional or different rules are needed for such products.

Finally, the proposed rule establishes a clear and conspicuous standard for the disclosure of rates in advertisements for home-secured loans. Under this standard, the information required to be disclosed by § 226.24(f)(2) must be disclosed with equal prominence and in close proximity to any advertised rate that triggered the required disclosures, except that the annual percentage rate may be disclosed with greater prominence than the other information.

Proposed comment 24(f)–1 would provide safe harbors for compliance with the equal prominence and close proximity standards. Proposed comment 24(f)–2 provides a cross-reference to comment 24(b)–2, which provides further guidance on the clear and conspicuous standard in this context.

226.24(f)(3)—Disclosure of Payments

Proposed § 226.24(f)(3) addresses the disclosure of payments. Under the proposed rule, if an advertisement for credit secured by a dwelling states the amount of any payment, the advertisement must disclose the following information in a clear and conspicuous manner: (a) The amount of each payment that will apply over the term of the loan, including any balloon payment. In variable-rate transactions, payments that will be determined based on application of an index and margin must be disclosed based on a reasonably current index and margin; (b) the period of time during which each payment will apply; and (c) in an advertisement for credit secured by a first lien on a dwelling, the fact that the payments do not include amounts for taxes and insurance premiums, if applicable, and that the actual payment obligation will be greater. These requirements are in addition to the disclosure requirements of current § 226.24(c).

Proposed comment 24(f)(3)–2 would specifically address how this requirement applies in the context of advertisements for variable-rate transactions. For such transactions, if the payment that applies at consummation is based on the index and margin that will be used to make subsequent payment adjustments over the term of the loan, then there is only one payment that must be disclosed and the requirements of § 226.24(f)(3) do not apply. If, however, the payment that applies at consummation is not based on the index and margin that will be used to make subsequent payment adjustments over the term of the loan, then there is more than one payment that must be disclosed and the requirements of § 226.24(f)(3) apply.

The proposed rule establishes a clear and conspicuous standard for the disclosure of payments in advertisements for home-secured loans. Under this standard, the information required to be disclosed under § 226.24(f)(3) regarding the amounts and time periods of payments must be disclosed with equal prominence and in close proximity to any advertised payment that triggered the required disclosures. The information required to be disclosed under § 226.24(f)(3) regarding the fact that taxes and insurance premiums are not included in the payment must be prominently disclosed and in close proximity to the advertised payments. The Board believes that requiring the disclosure about taxes and insurance premiums to be equally prominent could distract consumers from the key payment and time period information. As noted above, proposed comment 24(f)–1 would provide safe harbors for compliance with the equal prominence and close proximity standards. Proposed comment 24(f)–2 provides a cross-reference to the comment 24(b)–2, which provides further guidance regarding the application of the clear and conspicuous standard in this context.

Proposed comment 24(f)–3 clarifies how the rules on disclosures of rates and payments in advertisements apply to the use of comparisons in advertisements. This comment covers both rate and payment comparisons, but in practice, comparisons in advertisements usually focus on payments.

Proposed comment 24(f)(3)–1 clarifies that the requirement to disclose the amounts and time periods of all payments that will apply over the term of the loan may require the disclosure of several payment amounts, including any balloon payment. The comment provides an illustrative example.

Proposed comment 24(f)–5 would provide safe harbors for what constitutes a ''reasonably current index and margin'' as used in § 226.24(f). Under the proposed comment, the time period during which an index and margin would be considered reasonably current would depend on the medium in which the advertisement was distributed. For direct mail advertisements, a reasonably current index and margin would be one that was in effect within 60 days before mailing. For advertisements in electronic form, a reasonably current index and margin would be one that was in effect within 30 days before the advertisement was sent to a consumer's e-mail address, or for advertisements made on an Internet Web site, when viewed by the public. For printed advertisements made available to the general public, a reasonably current index and margin would be one that was in effect within 30 days before printing.

226.24(f)(4)—Envelope Excluded

Proposed § 226.24(f)(4) provides that the requirements of §§ 226.24(f)(2) and (3) do not apply to envelopes or to banner advertisements and pop-up advertisements that are linked to an electronic application or solicitation provided electronically. In the Board's view, banner advertisements and pop-up advertisements are similar to envelopes in the direct mail context.

226.24(g)—Alternative Disclosures—Television or Radio Advertisements

The Board is proposing to add a new § 226.24(g) to allow alternative disclosures to be provided in oral television and radio advertisements pursuant to its authority under TILA §§ 105(a), 122, and 144. One option would be to state each of the disclosures required by current § 226.24(c)(2) at a speed and volume sufficient for a consumer to hear and comprehend them if a triggering term is stated in the advertisement. Another option would be for the advertisement to state orally the APR applicable to the loan, and the fact that the rate may be increased after consummation, if applicable, at a speed and volume sufficient for a consumer to hear and comprehend them. However, instead of orally disclosing the required information about the amount or percentage of the downpayment and the terms of repayment, the advertisement could provide a toll-free telephone number that the consumer may call to receive more information. Given the space and time constraints on television and radio advertisements, the required disclosures may go unnoticed by consumers or be difficult for them to retain. Thus, providing an alternative means of disclosure may be more effective in many cases given the nature of television and radio media.

This approach is consistent with the approach taken in the proposed revisions to the advertising rules for open-end plans (other than home-secured plans). *See* 72 FR 32948, 33064 (June 14, 2007). This approach is also similar, but not identical, to the approach taken in the advertising rules under Regulation M. *See* 12 CFR 213.7(f). Section 213.7(f)(1)(ii) of Regulation M permits a leasing advertisement made through television or radio to direct the consumer to a written advertisement in a publication of general circulation in a community served by the media station. The Board has not proposed this option because it may not provide sufficient, readily-accessible information to consumers who are shopping for a home-secured loan and because advertisers, particularly those advertising on a regional or national scale, are not likely to use this option.

226.24(h)—Tax Implications

Section 1302 of the Bankruptcy Act amends TILA Section 144(e) to address

advertisements that are disseminated in paper form to the public or through the Internet, as opposed to by radio or television, and that relate to an extension of credit secured by a consumer's principal dwelling that may exceed the fair market value of the dwelling. Such advertisements must include a statement that the interest on the portion of the credit extension that is greater than the fair market value of the dwelling is not tax deductible for Federal income tax purposes. 15 U.S.C. 1664(e). For such advertisements, the statute also requires inclusion of a statement that the consumer should consult a tax adviser for further information on the deductibility of the interest.

The Bankruptcy Act also requires that disclosures be provided at the time of application in cases where the extension of credit may exceed the fair market value of the dwelling. *See* 15 U.S.C. 1638(a)(15). The Board intends to implement the application disclosure portion of the Bankruptcy Act during its forthcoming review of closed-end and HELOC disclosures under TILA. However, the Board requested comment on the implementation of both the advertising and application disclosures under this provision of the Bankruptcy Act for open-end credit in its October 17, 2005, ANPR. 70 FR 60235, 60244 (Oct. 17, 2005). A majority of comments on this issue addressed only the application disclosure requirement, but some commenters specifically addressed the advertising disclosure requirement. One industry commenter suggested that the advertising disclosure requirement apply only in cases where the advertised product allows for the credit to exceed the fair market value of the dwelling. Other industry commenters suggested that the requirement apply only to advertisements for products that are intended to exceed the fair market value of the dwelling.

The Board proposes to add § 226.24(h) and comment 24(h)–1 to implement TILA Section 144(e). The Board's proposal clarifies that the new requirements apply to advertisements for home-secured loans where the advertised extension of credit may, by its terms, exceed the fair market value of the dwelling. The Board seeks comment on whether the new requirements should only apply to advertisements that state or imply that the creditor provides extensions of credit greater than the fair market value of the dwelling.

226.24(i)—Prohibited Acts or Practices in Mortgage Advertisements

Section 129(l)(2) of TILA gives the Board the authority to prohibit acts or practices in connection with mortgage loans that it finds to be unfair or deceptive. Section 129(l)(2) of TILA also gives the Board the authority to prohibit acts or practices in connection with the refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower. 15 U.S.C. 1639(l)(2). Through an extensive review of advertising copy and other outreach efforts described above, Board staff identified a number of acts or practices connected with mortgage and mortgage refinancing advertising that appear to be inconsistent with the standards set forth in Section 129(l)(2) of TILA. Accordingly, the Board is proposing to add § 226.24(i) to prohibit seven acts or practices connected with advertisements of home-secured loans. The Board solicits comment on the appropriateness of the seven proposed prohibitions and whether any additional acts or practices should be prohibited by the regulation.

226.24(i)(1)—Misleading Advertising for ''Fixed'' Rates, Payments or Loans

Advertisements for home-secured loans often refer to a rate or payment, or to the credit transaction, as ''fixed.'' Such a reference is appropriate when used to denote a fixed-rate mortgage in which the rate or payment amounts do not change over the full term of the loan. Indeed, some credit counselors often encourage consumers to shop only for fixed-rate mortgages.

The Board has found that some advertisements also use the term ''fixed'' in connection adjustable-rate mortgages, or with fixed-rate mortgages that include low initial payments that will increase. Some of these advertisements make clear that the rate or payment is only ''fixed'' for a defined period of time, but after that the rate or payment may increase. For example, one advertisement reviewed prominently discloses that the product is an ''Adjustable-Rate Mortgage'' in large type, and clearly discloses in standard type that the rate is ''fixed'' for the first three, five, or seven years depending upon the product selected and may increase after that.

However, other advertisements do not adequately disclose that the interest rate or payment amounts are ''fixed'' only for a limited period of time, rather than for the full term of the loan. For example, some advertisements reviewed prominently refer to a ''30-Year Fixed Rate Loan'' or ''Fixed Pay Rate Loan'' on the first page. A footnote on the last page of the advertisements discloses in small type that the loan product is a payment option ARM in which the fully indexed rate and fully amortizing payment will be applied after the first five years. The Board finds that the use of the word ''fixed'' in this manner can mislead consumers into believing that the advertised product is a fixed-rate mortgage with rates and payments that will not change during the term of the loan.

Proposed § 226.24(i)(1) would prohibit the use of the term ''fixed'' in advertisements for credit secured by a dwelling, unless certain conditions are satisfied. The proposal would prohibit the use of the term ''fixed'' in advertisements for variable-rate transactions, unless two conditions are satisfied. First, the phrase ''Adjustable-Rate Mortgage'' or ''Variable-Rate Mortgage'' must appear in the advertisement before the first use of the word ''fixed'' and be at least as conspicuous as every use of the word ''fixed.'' Second, each use of the word ''fixed'' must be accompanied by an equally prominent and closely proximate statement of the time period for which the rate or payment is fixed and the fact that the rate may vary or the payment may increase after that period. Based on the advertising copy reviewed, particularly the first example described above, the Board believes there are legitimate and appropriate circumstances for using the term ''fixed,'' even in advertisements for variable-rate transactions. Therefore, the Board is not proposing an absolute ban on use of the term ''fixed'' in advertisements for variable-rate transactions. The Board believes that this more targeted approach will curb deceptive advertising practices.

The proposal would also prohibit the use of the term ''fixed'' to refer to the advertised payment in advertisements solely for transactions other than variable-rate transactions where the advertised payment may increase (*i.e.*, fixed-rate mortgage transactions with an initial lower payment that will increase), unless each use of the word ''fixed'' to refer to the advertised payment is accompanied by an equally prominent and closely proximate statement of the time period for which the payment is fixed and the fact that the payment may increase after that period.

Finally, the proposal would prohibit the use of the term ''fixed'' in advertisements for both variable-rate transactions and non-variable-rate

transactions, unless certain conditions are satisfied. First, the phrase ''Adjustable-Rate Mortgage,'' ''Variable-Rate Mortgage,'' or ''ARM'' must appear in the advertisement with equal prominence as any use of the word ''fixed.'' Second, each use of the term ''fixed'' to refer to a rate, payment, or to the credit transaction, must clearly refer solely to transactions for which rates are fixed and, if used to refer to an advertised payment, be accompanied by an equally prominent and closely proximate statement of the time period for which the advertised payment is fixed and the fact that the payment will increase after that period. Third, if the term ''fixed'' refers to the variable-rate transactions, it must be accompanied by an equally prominent and closely proximate statement of a time period for which the rate or payment is fixed, and the fact that the rate may vary or the payment may increase after that period.

The Board believes that this approach balances the need to protect consumers from misleading advertisements about the terms that are ''fixed,'' while ensuring that advertisers can continue to use the term ''fixed'' for legitimate, non-deceptive purposes in advertisements for home-secured loans, including variable-rate transactions.

226.24(i)(2)—Misleading Comparisons in Advertisements

Some advertisements for home-secured loans make comparisons between an actual or hypothetical consumer's current rate or payment obligations and the rates or payments that would apply if the consumer obtains the advertised product. The advertised rates or payments used in these comparisons frequently are low introductory ''teaser'' rates or payments that will not apply over the full term of the loan, and do not include amounts for taxes or insurance premiums. In addition, the current rate or payment obligations used in these comparisons frequently include not only the consumer's mortgage payment, but also possible payments for short-term, non-home secured, or revolving credit obligations, such as auto loans, installment loans, or credit card debts.

The Board finds that making comparisons in advertisements can be misleading if the advertisement compares the consumer's current payments or rates to payments or rates available for the advertised product that will only be in effect for a limited period of time, rather than for the term of the loan. Similarly, the Board finds that such comparisons can be misleading if the consumer's current payments include amounts for taxes and insurance premiums, but the payments for the advertised product do not include those amounts. These practices make comparison between the consumer's current obligations and the lower advertised rates or payments misleading.

Proposed § 226.24(i)(2) would prohibit any advertisement for credit secured by a dwelling from making any comparison between an actual or hypothetical consumer's current payments or rates and the payment or simple annual rate that will be available under the advertised product for less than the term of the loan, unless two conditions are satisfied. First, the comparison must include with equal prominence and in close proximity to the ''teaser'' payment or rate, all applicable payments or rates for the advertised product that will apply over the term of the loan and the period of time for which each applicable payment or simple annual rate will apply. Second, the advertisement must include a prominent statement in close proximity to the advertised payments that such payments do not include amounts for taxes and insurance premiums, if applicable. In the case of advertisements for variable-rate transactions where the advertised payment or simple annual rate is based on the index and margin that will be used to make subsequent rate or payment adjustments over the term of the loan, the comparison must include: (a) An equally prominent statement in close proximity to the advertised payment or rate that the payment or rate is subject to adjustment and the time period when the first adjustment will occur; and (b) a prominent statement in close proximity to the advertised payment that the payment does not include amounts for taxes and insurance premiums, if applicable.

Proposed comment 24(i)–1 would clarify that a misleading comparison includes a claim about the amount that a consumer may save under the advertised product. For example, a statement such as ''save $600 per month on a $500,000 loan'' constitutes an implied comparison between the advertised product's payment and a consumer's current payment.

The Board is not proposing to prohibit comparisons that take into account the consolidation of non-mortgage credit, such as auto loans, installment loans, or revolving credit card debt, into a single, home-secured loan. Debt consolidation can be beneficial for some consumers. Prohibiting the use of comparisons in advertisements that are based solely on low introductory ''teaser'' rates or payments should address abusive practices in advertisements focused on debt consolidation. The Board solicits comment on whether comparisons based on the assumed refinancing of non-mortgage debt into a new home-secured loan are associated with abusive lending practices or otherwise not in the interest of the borrower and should therefore be prohibited as well.

226.24(i)(3)—Misrepresentations About Government Endorsement

Some advertisements for home-secured loans characterize the products offered as ''government loan programs,'' ''government-supported loans,'' or otherwise endorsed or sponsored by a federal or state government entity, even though the advertised products are not government-supported loans, such as FHA or VA loans, or otherwise endorsed or sponsored by any federal, state, or local government entity. The Board finds that such advertisements can mislead consumers into believing that the government is guaranteeing, endorsing, or supporting the advertised loan product. Proposed § 226.24(i)(3) would prohibit such statements unless the advertisement is for an FHA loan, VA loan, or similar loan program that is, in fact, endorsed or sponsored by a federal, state, or local government entity. Proposed comment 24(i)–2 illustrates that a misrepresentation about government endorsement includes a statement that the federal Community Reinvestment Act entitles the consumer to refinance his or her mortgage at the new low rate offered in the advertisement is prohibited because it conveys to the consumer a misleading impression that the advertised product is endorsed or sponsored by the federal government.

226.24(i)(4)—Misleading Use of the Current Mortgage Lender's Name

Some advertisements for home-secured loans prominently display the name of the consumer's current mortgage lender, while failing to disclose or to disclose adequately the fact that the advertisement is by a mortgage lender that is not associated with the consumer's current lender. The Board finds that such advertisements may mislead consumers into believing that their current lender is offering the loan advertised or that the loan terms stated in the advertisement constitute a reduction in the consumer's payment amount or rate, rather than an offer to refinance the current loan with a different creditor. Proposed § 226.24(i)(4) would prohibit any advertisement for a home-secured loan, such as a letter, that is not sent by or on behalf of the consumer's current

lender from using the name of the consumer's current lender, unless the advertisement also discloses with equal prominence: (a) The name of the person or creditor making the advertisement; and (b) a clear and conspicuous statement that the person making the advertisement is not associated with, or acting on behalf of, the consumer's current lender.

226.24(i)(5)—Misleading Claims of Debt Elimination

Some advertisements for home-secured loans include statements that promise to eliminate, cancel, wipe-out, waive, or forgive debt. The Board finds that such advertisements can mislead consumers into believing that they are entering into a debt forgiveness program rather than merely replacing one debt obligation with another. Proposed § 226.24(i)(5) would prohibit advertisements for credit secured by a dwelling that offer to eliminate debt, or waive or forgive a consumer's existing loan terms or obligations to another creditor. Proposed comment 24(i)–3 provides examples of claims that would be prohibited. These include the following claims: ''Wipe-Out Personal Debts!'', ''New DEBT-FREE Payment'', ''Set yourself free; get out of debt today'', ''Refinance today and wipe your debt clean!'', ''Get yourself out of debt * * * Forever!'', and, in the context of an advertisement referring to a consumer's existing obligations to another creditor, ''Pre-payment Penalty Waiver.'' The proposed comment would also clarify that this provision does not prohibit an advertisement for a home-secured loan from claiming that the advertised product may reduce debt payments, consolidate debts, or shorten the term of the debt.

226.24(i)(6)—Misleading Claims Suggesting a Fiduciary or Other Relationship

Some advertisements for home-secured loans attempt to create the impression that the mortgage broker or lender, its employees, or its subcontractors, have a fiduciary relationship with the consumer. The Board finds that such advertisements may mislead consumers into believing that the broker or lender will consider only the consumer's best interest in offering a mortgage loan to the consumer, when, in fact, the broker or lender may be considering its own interests. Proposed § 226.24(i)(6) would prohibit advertisements for credit secured by a dwelling from using the terms ''counselor'' or ''financial advisor'' to refer to a for-profit mortgage broker or lender, its employees, or persons working for the broker or lender that are involved in offering, originating or selling mortgages. The Board recognizes that counselors and financial advisors do play a legitimate role in assisting consumers in selecting appropriate home-secured loans. Nothing in this rule would prohibit advertisements for bona fide consumer credit counseling services, such as counseling services provided by non-profit organizations, or bona fide financial advisory services, such as services provided by certified financial planners.

226.24(i)(7)—Misleading Foreign-Language Advertisements

Some advertisements for home-secured loans are targeted to non-English speaking consumers. In general, this is an appropriate means of promoting home ownership or offering loans to under-served, immigrant communities. In some of these advertisements, however, information about some of the trigger terms or required disclosures, such as a low introductory ''teaser'' rate or payment, is provided in a foreign language, while information about other trigger terms or required disclosures, such as the fully-indexed rate or fully amortizing payment, is provided only in English. The Board finds that this practice can mislead non-English speaking consumers who may not be able to comprehend the important English-language disclosures. Proposed § 226.24(i)(7) would prohibit advertisements for home-secured loans from providing information about some trigger terms or required disclosures, such as an initial rate or payment, only in a foreign language, but providing information about other trigger terms or required disclosures, such as information about the fully-indexed rate or fully amortizing payment, only in English. Advertisements that provide all disclosures in both English and a foreign language or advertisements that are entirely in English or entirely in a foreign language would not be affected by this prohibition.

XI. Mortgage Loan Disclosures

A. Early Mortgage Loan Disclosures—§ 226.19

TILA Section 128(b)(1) provides that the primary closed-end disclosure (referred to in this subpart as the ''mortgage loan disclosure''), which includes the annual percentage rate (APR) and other material disclosures, must be delivered ''before the credit is extended.'' 15 U.S.C. 1638(b)(1). A separate rule applies to residential mortgage transactions subject to the Real Estate Settlement Procedures Act (RESPA) and requires that ''good faith estimates'' of the mortgage loan disclosure be made ''before the credit is extended, or shall be delivered or placed in the mail not later than three business days after the creditor receives the consumer's written application, whichever is earlier.'' 15 U.S.C. 1638(b)(2).

The Board proposes to amend Regulation Z to extend the early mortgage loan disclosure requirement for residential mortgage transactions to other types of closed-end mortgage transactions, including mortgage refinancings, home equity loans, and reverse mortgages. Consistent with the existing requirement for residential mortgage transactions, this requirement would be limited to transactions secured by a consumer's principal dwelling. The Board also proposes to require that the early mortgage loan disclosure be delivered before the consumer pays a fee to any person for these transactions. The Board is proposing an exception to the fee restriction, however, for obtaining information on the consumer's credit history.

This proposal is made pursuant to TILA Section 105(a), which mandates that the Board prescribe regulations to carry out TILA's purposes, and authorizes the Board to create such classifications, differentiations, or other provisions, and to provide for such adjustments and exceptions for any class of transactions, as in the judgment of the Board are necessary or proper to effectuate the purposes of TILA, to prevent circumvention or evasion thereof, or to facilitate compliance therewith. 15 U.S.C. 1604(a). TILA Section 102(a) provides, in pertinent part, that the Act's purposes are to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit. 15 U.S.C. 1601(a). The proposal is intended to help consumers make informed use of credit and shop among available credit alternatives.

Under the current rule, creditors need not deliver mortgage loan disclosures on non-purchase money mortgage transactions until consummation. By that time, consumers may not be in a position to make meaningful use of the disclosure. Once consumers have reached the settlement table, it is likely too late for them to use the disclosure to shop among mortgages or to inform themselves adequately of the terms of the loan. Consumers are presented at

settlement with a large, often overwhelming, number of documents, and they may not reasonably be able to focus adequate attention on the mortgage loan disclosure. Moreover, by the time of loan consummation, consumers may feel committed to the loan because they are accessing their equity for an urgent need, or they have already paid substantial application fees.

The mortgage loan disclosure that consumers would receive early in the application process under this proposal includes a payment schedule, which would illustrate any increases in payments over time. The disclosure also would include an APR that reflects the fully indexed rate in cases of hybrid and payment-option ARMs, which sometimes are marketed on the basis of only an initial, discounted rate or a temporary, minimum payment. Providing this information within three days of application, before the consumer has paid a fee, would help ensure that consumers would have a genuine opportunity to review the credit terms being offered; ensure that the terms are consistent with their understanding of the transaction; assess whether the terms meet their needs and are affordable; and decide whether to go through with the transaction or continue to shop among alternatives.

Disclosure Before Fee Paid

The Board proposes to require that all of the early mortgage loan disclosures be delivered before the consumer pays a fee to any person in connection with the consumer's application for a mortgage transaction. Consumers typically pay fees to apply for a mortgage loan, such as fees for a credit report and property appraisal, as well as nonspecific ''application'' fees. If the fee is significant, a consumer may feel constrained from shopping for alternatives. This risk is particularly high in the subprime market, where consumers often are cash-strapped and where limited price transparency may obscure the benefits of continuing to shop. See part II.C for a discussion of these points. The risk also applies to the prime market, where many consumers would find significant a fee of several hundred dollars such as the fee often imposed for an appraisal and other services.

The proposed early disclosure obligation would be limited to fees paid in connection with an application for a mortgage transaction. This limitation is necessary because the obligation is triggered by a fee paid to any person, not just to the creditor. The Board seeks comment on whether further guidance is necessary to clarify what fees would be deemed in connection with an application.

The Board is proposing an exception to the fee restriction, however, for obtaining information on the consumer's credit history. The proposed exception to the fee restriction recognizes that creditors generally cannot make accurate transaction-specific estimates without having considered the consumer's credit history. To require creditors to bear the cost of reviewing credit history with little assurance the customer will apply for a loan may be unduly burdensome and could undermine the utility of the disclosures. The proposed exception would allow creditors to recoup the bona fide and reasonable amount necessary to obtain a credit report or other, similar form of information on the consumer's credit history.

The Board expects this proposal would impose additional costs on creditors, some of which may be passed on in part to consumers. Some creditors already deliver early mortgage loan disclosures on non-purchase money mortgages. Not all creditors, however, follow this practice, and those that do not would face increased costs, both one-time costs to modify their systems and ongoing costs to originate loans. The Board seeks comment on whether the benefits of this proposal outweigh these costs or other costs commenters identify.

Corresponding changes also would be made to the staff commentary, and certain other conforming amendments to Regulation Z and the staff commentary also are proposed.

B. Future Plans To Improve Disclosure

The Board remains committed to its longstanding belief that better information in the mortgage market can improve competition and help consumers make better decisions. This proposal contains new rules to prevent incomplete or misleading mortgage loan advertisements and solicitations, and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them. The Board recognizes that these disclosures need to be updated to reflect the increased complexity of mortgage products. In early 2008, the Board will begin testing current TILA mortgage disclosures and potential revisions to these disclosures through one-on-one interviews with consumers. The Board expects that this testing will identify potential improvements for the Board to propose for public comment in a separate rulemaking.

XII. Civil Liability and Remedies; Administrative Enforcement

Consumer Remedies for Unfair, Deceptive, or Abusive Practices

The restrictions on loan terms and lending practices in proposed §§ 226.35 and 226.36, as well as the advertising restrictions in proposed § 226.24(i), are based on the Board's authority under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2). Consumers who bring timely actions against creditors for violations of these restrictions may be able to recover: (i) Actual damages; (ii) statutory damages in an individual action of up to $2,000 or, in a class action, total statutory damages for the class of up to $500,000 or one percent of the creditor's net worth, whichever is less; (iii) special statutory damages equal to the sum of all finance charges and fees paid by the consumer; and (iv) court costs and attorney fees. TILA Section 130(a), 15 U.S.C. 1640(a).[72]

If a loan is a HOEPA loan—that is, its APR or fees exceed the triggers in § 226.32(a)—and the creditor has assigned it to another person, consumers may be able to obtain from the assignee all of the foregoing damages, including the finance charges and fees paid by the consumer. TILA Section 131(d), 15 U.S.C. 1641(d). For all other loans, TILA Section 131(e), 15 U.S.C. 1641(e), limits the liability of assignees for violations of Regulation Z to disclosure violations that are apparent on the face of the disclosure statement required by TILA.

TILA does not authorize private civil actions against parties other than creditors and assignees. A creditor is the party to whom the debt is initially payable. TILA Section 103(f), 15 U.S.C. 1602(f). A mortgage broker is not a creditor unless the debt is initially payable to the broker. Loan servicers may be creditors, but often they are not. Neither is a servicer treated as an assignee under TILA if the servicer is or was the owner of the obligation only for

[72] Section 130(a), 15 U.S.C. 1640(a), authorizes recovery of amounts of types (i), (ii), and (iv) from a creditor for a failure to comply with any requirement imposed under Chapter 2, which includes Section 129, 15 U.S.C. 1639. Section 130(a)(4), 15 U.S.C. 1640(a)(4), further authorizes recovery of amounts of type (iii) for a failure to comply with any requirement under Section 129, 15 U.S.C. 1639, unless the creditor demonstrates that the failure to comply is not material. Under TILA Section 103(y), 15 U.S.C. 1602(y), a reference to a requirement imposed under TILA or any provision thereof also includes a reference to the regulations of the Board under TILA or the provision in question. Therefore, Section 130(a), 15 U.S.C. 1640(a), authorizes recovery from a creditor of amounts of all four types if the creditor fails to comply with a Board regulation adopted under authority of Section 129(l)(2), 15 U.S.C. 1639(l)(2).

purposes of administrative convenience in servicing the obligation. TILA Section 131(f), 15 U.S.C. 1641(f).

A Consumer's Right to Rescind

A consumer has a right to rescind a transaction for up to three years after consummation when the mortgage contains a provision prohibited by a rule adopted under authority of TILA Section 129(l)(2). *See* TILA Sections 125 and 129(j), 15 U.S.C. 1636 and 1639(j). Moreover, any consumer who has the right to rescind a transaction may rescind the transaction as against any assignee. TILA Section 131(c), 15 U.S.C. 1641(c). The right of rescission does not extend, however, to home purchase loans, construction loans, or certain refinancings with the same creditor. TILA Section 125(e), 15 U.S.C. 1636.

Under current Regulation Z, 12 CFR 226.23(a)(3), footnote 48, a HOEPA loan having a prepayment penalty that does not conform to the requirements of § 226.32(d)(7) is a mortgage containing a provision prohibited by TILA Section 129, 15 U.S.C. 1639, and, therefore, is subject to the three-year right of the consumer to rescind. Proposed § 226.35(b)(3), which would be adopted under authority of Section 129(l)(2), 15 U.S.C. 1639(l)(2), would apply the restrictions on prepayment penalties in § 226.32(d)(6) and (7) to higher-priced mortgage loans, as defined in proposed § 226.35(a). Accordingly, the Board is proposing to revise footnote 48 to clarify that a higher-priced mortgage loan (whether or not it is a HOEPA loan) having a prepayment penalty that does not conform to the requirements of § 226.32(d)(7), as incorporated in § 226.35(b)(3), is also subject to a three-year right of rescission. (As mentioned, however, the right of rescission does not extend to home purchase loans, construction loans, or certain refinancings with the same creditor.) Other rules the Board is proposing would not be prohibitions of particular provisions of mortgages, and violations of those rules therefore would not trigger the extended right of rescission.

Advertising Rules and Civil Liability

The Board's proposal in connection with advertising practices presents a unique case with respect to civil liability under TILA. TILA Section 130 provides for civil liability of creditors for violations only of chapters 2, 4, and 5 of the act, 15 U.S.C. 1640(a), whereas the advertising provisions of TILA are found in chapter 3. Accordingly, the Board's proposed rules relating to advertising disclosures, such as the disclosures about rates or payments, would not create civil liability for creditors, assignees, or other persons, because those rules would be promulgated under the Board's general rulemaking authority in TILA Section 105(a), 15 U.S.C. 1604(a). These proposed rules would, however, be subject to administrative enforcement by appropriate agencies.

Proposed § 226.24(i), which would prohibit certain acts or practices in connection with closed-end advertisements for credit secured by a dwelling, would be promulgated under the Board's authority in TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2). Section 130(a), 15 U.S.C. 1640(a), authorizes a civil action by any person against a creditor who fails to comply with respect to that person with a rule adopted under authority of Section 129(l)(2), 15 U.S.C. 1639(l)(2). It is not clear, however, whether a consumer may bring an action against a creditor under Section 130(a), 15 U.S.C. 1640(a), for violating an advertising restriction in proposed § 226.24(i) if the consumer has not obtained a mortgage loan from the creditor.

Administrative Enforcement

In addition to providing consumers remedies against creditors and assignees, the statute authorizes various agencies to enforce Regulation Z administratively against various parties. The federal banking agencies may enforce the regulation against banks and thrifts. TILA Section 108(a), 15 U.S.C. 1607(a). The Federal Trade Commission (FTC) is generally authorized to enforce violations of Regulation Z as to any other entity or individual. TILA Section 108(c), 15 U.S.C. 1607(c). State attorneys general may enforce violations of regulations adopted under authority of TILA Section 129(l)(2). See TILA Section 130(e), 15 U.S.C. 1640(e).

XIII. Effective Date

Under TILA, the Board's disclosure regulations are to have an effective date of that October 1 which follows by at least six months the date of promulgation. TILA Section 105(d), 15 U.S.C. 1604(d). However, the Board may, at its discretion, lengthen the implementation period for creditors to adjust their forms to accommodate new requirements, or shorten the period where the Board makes a specific finding that such action is necessary to prevent unfair or deceptive disclosure practices. *Id.* The Board requests comment on whether six months would be an appropriate implementation period for the proposed rules. Specifically, the Board requests comment on the length of time creditors may need to implement the proposed rules, as well as on whether the Board should specify a shorter implementation period for certain provisions in order to prevent unfair or deceptive practices.

XIV. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3506; 5 CFR Part 1320 Appendix A.1), the Board reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget (OMB). The collection of information that is required by this proposed rule is found in 12 CFR part 226. The Federal Reserve may not conduct or sponsor, and an organization is not required to respond to, this information collection unless the information collection displays a currently valid OMB control number. The OMB control number is 7100–0199.

This information collection is required to provide benefits for consumers and is mandatory (15 U.S.C. 1601 *et seq.*). The respondents/recordkeepers are creditors and other entities subject to Regulation Z, including for-profit financial institutions and small businesses.

TILA and Regulation Z are intended to ensure effective disclosure of the costs and terms of credit to consumers. For open-end credit, creditors are required, among other things, to disclose information about the initial costs and terms and to provide periodic statements of account activity, notices of changes in terms, and statements of rights concerning billing error procedures. Regulation Z requires specific types of disclosures for credit and charge card accounts and home-equity plans. For closed-end loans, such as mortgage and installment loans, cost disclosures are required to be provided prior to consummation. Special disclosures are required in connection with certain products, such as reverse mortgages, certain variable-rate loans, and certain mortgages with rates and fees above specified thresholds. TILA and Regulation Z also contain rules concerning credit advertising. Creditors are required to retain evidence of compliance for twenty-four months (12 CFR 226.25), but Regulation Z does not specify the types of records that must be retained.

Under the PRA, the Federal Reserve accounts for the paperwork burden associated with Regulation Z for the state member banks and other creditors supervised by the Federal Reserve that engage in lending covered by Regulation Z and, therefore, are respondents under the PRA. Appendix I of Regulation Z defines the Federal Reserve-regulated institutions as: state member banks,

branches and agencies of foreign banks (other than federal branches, federal agencies, and insured state branches of foreign banks), commercial lending companies owned or controlled by foreign banks, and organizations operating under section 25 or 25A of the Federal Reserve Act. Other federal agencies account for the paperwork burden on other creditors. Paperwork burden associated with entities that are not creditors will be accounted for by other federal agencies. The current total annual burden to comply with the provisions of Regulation Z is estimated to be 552,398 hours for the 1,172 Federal Reserve-regulated institutions that are deemed to be respondents for the purposes of the PRA. To ease the burden and cost of complying with Regulation Z (particularly for small entities), the Federal Reserve provides model forms, which are appended to the regulation.

The proposed rule would impose a one-time increase in the total annual burden under Regulation Z for all respondents regulated by the Federal Reserve by 46,880 hours, from 552,398 to 599,278 hours.

The total estimated burden increase, as well as the estimates of the burden increase associated with each major section of the proposed rule as set forth below, represents averages for all respondents regulated by the Federal Reserve. The Federal Reserve expects that the amount of time required to implement each of the proposed changes for a given institution may vary based on the size and complexity of the respondent. Furthermore, the burden estimate for this rulemaking does not include the burden addressing changes to format, timing, and content requirements for the five main types of open-end credit disclosures governed by Regulation Z as announced in a separate proposed rulemaking (Docket No. R–1286).

The Federal Reserve proposes revisions to §§ 226.16 and 226.24 to require that advertisements provide accurate and balanced information, in a clear and conspicuous manner. Additional proposed revisions to § 226.24 would prohibit advertisements that are deceptive.

The proposed changes to the advertising provisions would amend the open-end home-equity plan advertising rules in § 226.16 and amend the closed-end credit advertising rules in § 226.24. The two most significant changes in § 226.16 relate to the clear and conspicuous standard and the advertisement of introductory terms in home-equity plans. The three most significant changes in § 226.24 relate to strengthening the clear and conspicuous standard for advertising disclosures, regulating the disclosure of rates and payments in advertisements to ensure that low introductory or ''teaser'' rates or payments are not given undue emphasis, and prohibiting certain acts or practices in advertisements that the Federal Reserve finds inconsistent with the standards set forth in TILA Section 129(l)(2). The Federal Reserve estimates that 1,172 respondents regulated by the Federal Reserve would take, on average, 40 hours (one business week) to revise and update their advertising materials to comply with the proposed disclosure requirements in §§ 226.16 and 226.24. These one-time revisions would increase the burden by 46,880 hours.

The other federal agencies are responsible for estimating and reporting to OMB the total paperwork burden for the institutions for which they have administrative enforcement authority. They may, but are not required to, use the Federal Reserve's burden estimates. Using the Federal Reserve's method, the total current estimated annual burden for all financial institutions subject to Regulation Z, including Federal Reserve-supervised institutions, would be approximately 61,656,695 hours. The proposed rule would increase the estimated annual burden for all institutions subject to Regulation Z by 772,000 hours to 62,428,695 hours. The above estimates represent an average across all respondents and reflect variations between institutions based on their size, complexity, and practices. All covered institutions, of which there are approximately 19,300, potentially are affected by this collection of information, and thus are respondents for purposes of the PRA.

Comments are invited on: (1) Whether the proposed collection of information is necessary for the proper performance of the Federal Reserve's functions; including whether the information has practical utility; (2) the accuracy of the Federal Reserve's estimate of the burden of the proposed information collection, including the cost of compliance; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology. Comments on the collection of information should be sent to Michelle Shore, Federal Reserve Board Clearance Officer, Division of Research and Statistics, Mail Stop 151–A, Board of Governors of the Federal Reserve System, Washington, DC 20551, with copies of such comments sent to the Office of Management and Budget, Paperwork Reduction Project (7100–0199), Washington, DC 20503.

XV. Initial Regulatory Flexibility Analysis

In accordance with section 3(a) of the Regulatory Flexibility Act (RFA), 5 U.S.C. §§ 601–612, the Board is publishing an initial regulatory flexibility analysis for the proposed amendments to Regulation Z. The RFA requires an agency either to provide an initial regulatory flexibility analysis with a proposed rule or certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. An entity is considered ''small'' if it has $165 million or less in assets for banks and other depository institutions; and $6.5 million or less in revenues for non-bank mortgage lenders, mortgage brokers, and loan servicers.[73]

Based on its analysis and for the reasons stated below, the Board believes that this proposed rule will have a significant economic impact on a substantial number of small entities. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period. The Board requests public comment in the following areas.

Reasons for the Proposed Rule

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

Congress enacted HOEPA in 1994 as an amendment to TILA. TILA is implemented by the Board's Regulation Z. HOEPA imposed additional substantive protections on certain high-cost mortgage transactions. HOEPA also authorized the Board to prohibit acts or

[73] U.S. Small Business Administration, Table of Small Business Size Standards Matched to North American Industry Classification System Codes; available at *http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf.*

practices in connection with mortgage loans that are unfair, deceptive, or designed to evade the purposes of HOEPA, and acts or practices in connection with refinancing of mortgage loans that are associated with abusive lending or are otherwise not in the interest of borrowers.

The proposed regulations would prohibit certain acts or practices in connection with closed-end mortgage loans to address problems that have been observed in the mortgage market, particularly the subprime market. Some of the proposed prohibitions or restrictions would apply only to higher-priced closed-end mortgage loans secured by the consumer's principal dwelling. These include: (1) Prohibiting a pattern or practice of extending credit based on the collateral without considering the borrower's ability to repay; (2) requiring creditors to establish escrow accounts for taxes and insurance for first-lien loans; (3) requiring creditors to verify income and assets they rely upon in making loans; and (4) prohibiting prepayment penalties except under certain conditions.

Other proposed prohibitions or restrictions would apply generally to closed-end mortgage loans secured by the consumer's principal dwelling. These include restrictions on certain creditor payments to brokers, a prohibition on coercion of appraisers, and a prohibition on certain mortgage loan servicing practices. Finally, the proposal would prohibit certain advertising practices in connection with closed-end mortgage loans secured by a consumer's dwelling.

The Board's proposal also would require certain TILA disclosures for closed-end mortgages to be provided to the consumer earlier in the loan process. The proposal would revise the Regulation Z advertising rules to ensure that advertisements for open-end and closed-end mortgage loans provide accurate and balanced information about rates and payments.

Statement of Objectives and Legal Basis

The **SUPPLEMENTARY INFORMATION** contains this information. In summary, the proposed amendments to Regulation Z are designed to achieve three goals: (1) Prohibit certain acts or practices for higher-priced mortgage loans secured by a consumer's principal dwelling and prohibit other acts or practices for closed-end mortgage loans secured by a consumer's principal dwelling; (2) revise the disclosures required in advertisements for credit secured by a consumer's dwelling and prohibit certain practices in connection with closed-end mortgage advertising; and (3) require disclosures for closed-end mortgages to be provided earlier in the transaction.

The legal basis for the proposed rule is in Sections 105(a), 122(a), and 129(l)(2) of TILA. A more detailed discussion of the Board's rulemaking authority is set forth in part V of the **SUPPLEMENTARY INFORMATION**.

Description of Small Entities to Which the Proposed Rule Would Apply

The proposed regulations would apply to all institutions and entities that engage in closed-end home-secured lending and servicing. The Board is not aware of a reliable source for the total number of small entities likely to be affected by the proposal, and the credit provisions of TILA and Regulation Z have broad applicability to individuals and businesses that originate, extend and service even small numbers of home-secured credit. *See* § 226.1(c)(1).[74] All small entities that originate, extend, or service closed-end loans secured by a consumer's dwelling potentially could be subject to the proposed rule.

The Board can, however, identify through data from Reports of Condition and Income (''call reports'') approximate numbers of small depository institutions that would be subject to the proposed rules. Based on December 2006 call report data, approximately 6,932 small institutions would be subject to the proposed rule. Approximately 17,618 depository institutions in the United States filed call report data, approximately 13,018 of which had total domestic assets of $165 million or less and thus were considered small entities for purposes of the Regulatory Flexibility Act. Of 4,558 banks, 615 thrifts and 7,691 credit unions that filed call report data and were considered small entities, 4,389 banks, 574 thrifts, and 5,104 credit unions, totaling 10,067 institutions, extended mortgage credit. For purposes of this analysis, thrifts include savings banks, savings and loan entities, co-operative banks and industrial banks.

	Filed call report data	Filed call report data and had assets <= $165M	Filed call report data and originated or extended mortgage credit	Filed call report data and originated or extended mortgage credit with assets <= $165M	Filed call report data and originated or extended mortgage credit with assets <= $165M and did not file HMDA
Commercial banks	7,423	4,558	7,210	4,389	2,808
Thrifts[75]	1,344	615	1,280	574	254
Credit unions	8,535	7,691	5,948	5,104	3,870
Other	316	154	0	0	0
Total	17,618	13,018	14,438	10,067	6,932

The Board cannot identify with certainty the number of small non-depository institutions that would be subject to the proposed rule. Home Mortgage Disclosure Act (HMDA)[76] data

[74] Regulation Z generally applies to ''each individual or business that offers or extends credit when four conditions are met: (i) The credit is offered or extended to consumers; (ii) the offering or extension of credit is done regularly, (iii) the credit is subject to a finance charge or is payable by a written agreement in more than four installments, and (iv) the credit is primarily for personal, family, or household purposes.'' § 226.1(c)(1).

[75] Thrifts include savings banks, savings and loan associations, co-operative and industrial banks.

[76] The 8,886 lenders (both depository institutions and mortgage companies) covered by HMDA in 2006 accounted for an estimated 80% of all home lending in the United States. Under HMDA, lenders use a ''loan/application register'' (HMDA/LAR) to report information annually to their federal supervisory agencies for each application and loan acted on during the calendar year. Lenders must make their HMDA/LARs available to the public by March 31 following the year to which the data relate, and they must remove the two date-related fields to help preserve applicants' privacy. Only lenders that have offices (or, for non-depository institutions, are deemed to have offices) in

Continued

indicate that 2,004 non-depository institutions filed HMDA reports in 2006.[77] Based on the small volume of lending activity reported by these institutions, most are likely to be small.

Certain parts of the proposal would apply to mortgage brokers and mortgage servicers. According to the National Association of Mortgage Brokers, in 2004 there were 53,000 mortgage brokerage companies that employed an estimated 418,700 people.[78] The Board believes that most of these companies are small entities.[79]

The proposal would prohibit certain unfair mortgage servicing practices. The Board is not aware, however, of a source of data for the number of small mortgage servicers. The available data are not sufficient for the Board to realistically estimate the number of mortgage servicers that would be subject to the proposed rule and that are small as defined by the Small Business Administration. The Board invites comment and information on the number and type of small entities affected by the proposed rule.

Projected Reporting, Recordkeeping, and Other Compliance Requirements

The compliance requirements of the proposed rules are described in parts VI through VIII and in parts X and XI of the **SUPPLEMENTARY INFORMATION**. The effect of the proposed revisions to Regulation Z on small entities is unknown. Some small entities would be required, among other things, to modify their underwriting practices and home-secured credit disclosures to comply with the revised rules. The precise costs to small entities of updating their systems, disclosures, and underwriting practices are difficult to predict. These costs will depend on a number of unknown factors, including, among other things, the specifications of the current systems used by such entities to prepare and provide disclosures and/or solicitations and to administer and maintain accounts, the complexity of the terms of credit products that they offer, and the range of such product offerings. Additionally, the proposed rules could affect how mortgage brokers are compensated. The precise costs that the proposed rule would impose on mortgage brokers are also difficult to ascertain. Nevertheless, the Board believes that these costs will have a significant economic effect on small entities, including mortgage brokers. The Board seeks information and comment on any costs, compliance requirements, or changes in operating procedures arising from the application of the proposed rule to small institutions.

Identification of Duplicative, Overlapping, or Conflicting Federal Rules

Other federal rules. The Board has not identified any federal rules that conflict with the proposed revisions to Regulation Z.

Overlap with RESPA. Certain terms defined in the proposed rule, such as ''escrow account,'' ''servicer'' and ''servicing,'' cross-reference existing definitions under the U.S. Department of Housing and Urban Development's (HUD) Regulation X (Real Estate Settlement Procedures Act (RESPA).

Overlap with HUD's guidance. The Board recognizes that HUD has issued policy statements regarding creditor payments to mortgage brokers under RESPA and guidance as to disclosure of such payments on the Good Faith Estimate and HUD–1 Settlement Statement. The Board is also aware that HUD has announced its intention to propose improved disclosures for broker compensation under RESPA in the near future. The Board intends that its proposal would complement any proposal by HUD. The proposed provision regarding creditor payments to brokers is intended to be consistent with HUD's existing guidance regarding broker compensation under Section 8 of RESPA.

Identification of Duplicative, Overlapping, or Conflicting State Laws

Certain sections of the proposed rules may result in inconsistency with certain state laws.

Escrows. Certain states have laws regulating escrows for taxes and insurance. Section 226.35(b)(4) would require creditors to establish escrow accounts for taxes and insurance for first-lien higher-priced loans, but allow creditors to allow borrowers to opt out of escrows 12 months after loan consummation. These provisions may be inconsistent with certain state laws that limit creditors' ability to require escrows or provide consumers with a right to opt out of an escrow sooner than 12 months after loan consummation.

Creditor payments to brokers. The Board is aware that many states regulate brokers and their compensation in various respects. Under TILA Section 111, the proposed rule would not preempt such state laws except to the extent they are inconsistent with the proposal's requirements. 15 U.S.C. 1610.

The Board seeks comment regarding any state or local statutes or regulations, that would duplicate, overlap, or conflict with the proposed rule.

Discussion of Significant Alternatives

The Board considered whether improved disclosures could protect consumers against unfair acts or practices in connection with closed-end mortgage loans secured by a consumer's principal dwelling as well as the proposed rule. While the Board anticipates proposing improvements to mortgage loan disclosures, it does not appear that better disclosures alone will address unfair, abusive, or deceptive practices in the mortgage market, including the subprime market.

The Board welcomes comments on any significant alternatives, consistent with the requirements of TILA, that would minimize the impact of the proposed rule on small entities.

List of Subjects in 12 CFR Part 226

Advertising, Consumer protection, 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. New language is shown inside bold arrows, and language that would be deleted is set off with bold brackets.

Authority and Issuance

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 is amended to read as follows:

Authority: 12 U.S.C. 3806; 15 U.S.C. 1604►,◄ **[**and**]** 1637(c)(5)►, and 1639(l)◄.

Subpart A—General

2. Section 226.1 is amended by revising paragraph (d)(5) to read as follows:

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

* * * * *

(d) * * *

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metropolitan areas are required to report under HMDA. However, if a lender is required to report, it must report information on all of its home loan applications and loans in all locations, including non-metropolitan areas.

[77] The 2006 HMDA Data, *http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06draft.pdf.*

[78] *http://www.namb.org/namb/Industry_Facts.asp?SnID=719224934*

[79] In the first quarter of 2007, 77% of brokers (NAICS 522310) had fewer than five employees; only 0.4% had 100 or more employees, thus it seems likely that most have revenues below the threshold. (Bureau of Labor Statistics' Quarterly Census of Employment and Wages).

(5) Subpart E contains special rules for mortgage transactions. Section 226.32 requires certain disclosures and provides limitations for loans that have rates and fees above specified amounts. Section 226.33 requires disclosures, including the total annual loan cost rate, for reverse mortgage transactions. Section 226.34 prohibits specific acts and practices in connection with mortgage transactions ► that are subject to § 226.32. Section 226.35 prohibits specific acts and practices in connection with higher-priced mortgage loans, as defined in § 226.35(a). Section 226.36 prohibits specific acts and practices in connection with credit secured by a consumer's principal dwelling◄.

* * * * *

Subpart B—Open-End Credit

3. Section 226.16 is amended by revising paragraphs (d)(1) through (d)(4), removing and reserving footnote 36e, and adding new paragraphs (d)(6) and (f) to read as follows:

§ 226.16 Advertising.

* * * * *

(d) *Additional requirements for home-equity plans*—(1) *Advertisement of terms that require additional disclosures.* If any of the terms required to be disclosed under § ►226.6(a)(1) or (2)◄ **[**226.6(a) or (b)**]** or the payment terms of the plan are set forth, affirmatively or negatively, in an advertisement for a home-equity plan subject to the requirements of § 226.5b, the advertisement also shall clearly and conspicuously set forth the following:

(i) Any loan fee that is a percentage of the credit limit under the plan and an estimate of any other fees imposed for opening the plan, stated as a single dollar amount or a reasonable range.

(ii) Any periodic rate used to compute the finance charge, expressed as an annual percentage rate as determined under § 226.14(b).

(iii) The maximum annual percentage rate that may be imposed in a variable-rate plan.

(2) *Discounted and premium rates.* If an advertisement states an initial annual percentage rate that is not based on the index and margin used to make later rate adjustments in a variable-rate plan, the advertisement also shall state ►with equal prominence and in close proximity to the initial rate:

(i) T◄**[**t**]**he period of time such ►initial◄ rate will be in effect►;◄ and**[**, with equal prominence to the initial rate,**]**

►(ii) A◄**[**a**]** reasonably current annual percentage rate that would have been in effect using the index and margin.

(3) *Balloon payment.* If an advertisement contains a statement **[**about**]** ►of◄ any minimum periodic payment ►and a balloon payment may result if only the minimum periodic payments are made, even if such a payment is uncertain or unlikely◄, the advertisement also shall state**[**, if applicable,**]** ►with equal prominence and in close proximity to the minimum periodic payment statement◄ that a balloon payment may result►, if applicable◄.[36e] ►A balloon payment results if paying the minimum periodic payments does not fully amortize the outstanding balance by a specified date or time, and the consumer is required to repay the entire outstanding balance at such time. If a balloon payment will occur when the consumer makes only the minimum payments required under the plan, an advertisement for such a program which contains any statement of any minimum periodic payment shall also state with equal prominence and in close proximity to the minimum periodic payment statement:

(i) That a balloon payment will result; and

(ii) The amount and timing of the balloon payment that will result if the consumer makes only the minimum payments for the maximum period of time that the consumer is permitted to make such payments.◄

(4) *Tax implications.* An advertisement that states that any interest expense incurred under the home-equity plan is or may be tax deductible may not be misleading in this regard. ►If an advertisement distributed in paper form or through the Internet (rather than by radio or television) is for a home-equity plan secured by the consumer's principal dwelling, and the advertised extension of credit may, by its terms, exceed the fair market value of the dwelling, the advertisement shall clearly and conspicuously state that:

(i) The interest on the portion of the credit extension that is greater than the fair market value of the dwelling is not tax deductible for Federal income tax purposes; and

(ii) The consumer should consult a tax adviser for further information regarding the deductibility of interest and charges.◄

* * * * *

►(6) *Introductory rates and payments.*

(i) *Definitions.* The following definitions apply for purposes if paragraph (d)(6) of this section.

(A) *Introductory rate.* The term ''introductory rate'' means, in a variable-rate plan, any annual percentage rate that is not based on the index and margin that will be used to make rate adjustments under the plan, if that rate is less than a reasonably current annual percentage rate that would be in effect under the index and margin that will be used to make rate adjustments under the plan.

(B) *Introductory payment.* The term ''introductory payment'' means—

(*1*) For a variable-rate plan, any payment applicable for an introductory period that:

(*i*) Is not derived by applying the index and margin to the outstanding balance when such index and margin will be used to determine other payments under the plan; and

(*ii*) Is less than other payments under the plan derived by applying a reasonably current index and margin that will be used to determine the amount of such payments, given an assumed balance.

(*2*) For a plan other than a variable-rate plan, any payment applicable for an introductory period if that payment is less than other payments that will be in effect under the plan given an assumed balance.

(C) *Introductory period.* An ''introductory period'' means a period of time, less than the full term of the loan, that the introductory rate or introductory payment may be applicable.

(ii) *Stating the term ''introductory''.* If any annual percentage rate is an introductory rate, or if any payment is an introductory payment, the term ''*introductory*'' or ''*intro*'' must be stated in immediate proximity to each listing of the introductory rate or payment.

(iii) *Stating the introductory period and post-introductory rate or payments.* If any annual percentage rate that may be applied to a plan is an introductory rate, or if any payment applicable to a plan is an introductory payment, the following must be disclosed in a clear and conspicuous manner with equal prominence and in close proximity to each listing of the introductory rate or payment:

(A) The period of time during which the introductory rate or introductory payment will apply;

(B) In the case of an introductory rate, any annual percentage rate that will apply under the plan. If such rate is variable, the annual percentage rate must be disclosed in accordance with the accuracy standards in §§ 226.5b, or 226.16(b)(1)(ii) as applicable; and

(C) In the case of an introductory payment, the amounts and time periods of any payments that will apply under the plan. In variable-rate transactions,

[36e] ►**[**Reserved.**]**◄ **[**See footnote 10b.**]**

payments that will be determined based on application of an index and margin shall be disclosed based on a reasonably current index and margin.

(iv) *Envelope excluded.* The requirements in paragraph (d)(6)(iii) of this section do not apply to an envelope in which an application or solicitation is mailed, or to a banner advertisement or pop-up advertisement linked to an application or solicitation provided electronically.◄

* * * * *

►(f) *Alternative disclosures—television or radio advertisements.* An advertisement made through television or radio stating any of the terms requiring additional disclosures under paragraph (b)(1) or (d)(1) of this section may alternatively comply with paragraph (b)(1) or (d)(1) of this section by stating the information required by paragraph (b)(1)(ii) of this section or paragraph (d)(1)(ii) of this section, as applicable, and listing a toll-free telephone number along with a reference that such number may be used by consumers to obtain additional cost information.◄

Subpart C—Closed-End Credit

4. Section 226.17 is amended by revising paragraph (b) and the introductory text of paragraph (f), and removing and reserving footnote 39 to read as follows:

§ 226.17 General disclosure requirements.

* * * * *

(b) *Time of disclosures.* The creditor shall make disclosures before consummation of the transaction. In certain **[**residential**]** mortgage transactions, special timing requirements are set forth in § 226.19(a). In certain variable-rate transactions, special timing requirements for variable-rate disclosures are set forth in § 226.19(b) and § 226.20(c). In certain transactions involving mail or telephone orders or a series of sales, the timing of the disclosures may be delayed in accordance with paragraphs (g) and (h) of this section.

* * * * *

(f) *Early disclosures.* If disclosures required by this subpart are given before the date of consummation of a transaction and a subsequent event makes them inaccurate, the creditor shall disclose before consummation ►(except that, for certain mortgage transactions, § 226.19(a)(2) permits redisclosure no later than consummation or settlement, whichever is later).◄ [39]—

* * * * *

5. Section 226.19 is amended by revising the heading and paragraph (a)(1) to read as follows:

§ 226.19 Certain [residential] mortgage and variable-rate transactions.

(a) **[***Residential m***]** ►M◄*ortgage transactions subject to RESPA*—(1)►(i)◄ *Time of disclosures.* In a **[**residential**]** mortgage transaction subject to the Real Estate Settlement Procedures Act (12 U.S.C. 2601 et seq.) ►that is secured by the consumer's principal dwelling, other than a home equity line of credit subject to § 226.5b,◄ the creditor shall make good faith estimates of the disclosures required by § 226.18 before consummation, or shall deliver or place them in the mail not later than three business days after the creditor receives the consumer's written application, whichever is earlier.

►(ii) *Imposition of fees.* Except as provided in paragraph (a)(1)(iii) of this section, neither a creditor nor any other person may impose a fee on the consumer in connection with the consumer's application for a mortgage transaction subject to paragraph (a)(1)(i) of this section before the consumer has received the disclosures required by paragraph (a)(1)(i) of this section. If the disclosures are mailed to the consumer, the consumer is considered to have received them three business days after they are mailed.

(iii) *Exception to fee restriction.* A creditor or other person may impose a fee for obtaining the consumer's credit report before the consumer has received the disclosure required by paragraph (a)(1)(i) of this section, provided the fee is *bona fide* and reasonable in amount.◄

* * * * *

6. Section 226.24 is revised to read as follows:

§ 226.24 Advertising.

(a) *Actually available terms.* If an advertisement for credit states specific credit terms, it shall state only those terms that actually are or will be arranged or offered by the creditor.

►(b) *Clear and conspicuous standard.* Disclosures required by this section shall be made clearly and conspicuously.◄

►(c)◄**[**(b)**]** *Advertisement of rate of finance charge.* If an advertisement states a rate of finance charge, it shall state the rate as an ''annual percentage rate,'' using that term. If the annual percentage rate may be increased after consummation, the advertisement shall state that fact.► If an advertisement is for credit not secured by a dwelling, t◄**[**T**]**he advertisement shall not state any other rate, except that a simple annual rate or periodic rate that is applied to an unpaid balance may be stated in conjunction with, but not more conspicuously than, the annual percentage rate.► If an advertisement is for credit secured by a dwelling, the advertisement shall not state any other rate, except that a simple annual rate that is applied to an unpaid balance may be stated in conjunction with, but not more conspicuously than, the annual percentage rate.◄

►(d)◄**[**(c)**]** *Advertisement of terms that require additional disclosures*—(1) ►*Triggering terms.*◄ If any of the following terms is set forth in an advertisement, the advertisement shall meet the requirements of paragraph ►(d)◄**[**(c)**]**(2) of this section:

(i) The amount or percentage of any downpayment.

(ii) The number of payments or period of repayment.

(iii) The amount of any payment.

(iv) The amount of any finance charge.

(2) ►*Additional terms.*◄ An advertisement stating any of the terms in paragraph ►(d)◄**[**(c)**]**(1) of this section shall state the following terms,[49] as applicable (an example of one or more typical extensions of credit with a statement of all the terms applicable to each may be used):

(i) The amount or percentage of the downpayment.

(ii) The terms of repayment ►, which reflect the repayment obligations over the full term of the loan, including any balloon payment◄.

(iii) The ''annual percentage rate,'' using that term, and, if the rate may be increased after consummation, that fact.

►(e)◄**[**(d)**]** *Catalogs or other multiple-page advertisements; electronic advertisements.*

(1) If a catalog or other multiple-page advertisement, or an electronic advertisement (such as an advertisement appearing on an Internet Web site), gives information in a table or schedule in sufficient detail to permit determination of the disclosures required by paragraph ►(d)◄**[**(c)**]**(2) of this section, it shall be considered a single advertisement if—

[39] ►**[**Reserved.**]**◄ **[**For certain residential mortgage transactions, section 226.19(a)(2) permits redisclosure no later than consummation or settlement, whichever is later.**]**

[49] ►**[**Reserved.**]**◄**[**An example of one or more typical extensions of credit with a statement of all the terms applicable to each may be used.**]**

(i) The table or schedule is clearly and conspicuously set forth; and

(ii) Any statement of the credit terms in paragraph ►(d)◄[(c)](1) of this section appearing anywhere else in the catalog or advertisement clearly refers to the page or location where the table or schedule begins.

(2) A catalog or other multiple-page advertisement or an electronic advertisement (such as an advertisement appearing on an Internet Web site) complies with paragraph ►(d)◄[(c)](2) of this section if the table or schedule of terms includes all appropriate disclosures for a representative scale of amounts up to the level of the more commonly sold higher-priced property or services offered.

►(f) *Disclosure of Rates and Payments in Advertisements for Credit Secured by a Dwelling.*

(1) *Scope.* The requirements of this paragraph apply to any advertisement for credit secured by a dwelling, other than television or radio advertisements, including promotional materials accompanying applications.

(2) *Disclosure of rates*—(i) *In general.* If an advertisement for credit secured by a dwelling states a simple annual rate of interest and more than one simple annual rate of interest will apply over the term of the advertised loan, the advertisement shall disclose in a clear and conspicuous manner:

(A) Each simple annual rate of interest that will apply. In variable-rate transactions, a rate determined by adding an index and margin shall be disclosed based on a reasonably current index and margin;

(B) The period of time during which each simple annual rate of interest will apply; and

(C) The annual percentage rate for the loan. If such rate is variable, the annual percentage rate shall comply with the accuracy standards in §§ 226.17(c) and 226.22.

(ii) *Clear and conspicuous requirement.* For purposes of paragraph (f)(2)(i) of this section, clearly and conspicuously disclosed means that the required information in paragraphs (f)(2)(i)(A) through (C) shall be disclosed with equal prominence and in close proximity to any advertised rate that triggered the required disclosures. The required information in paragraph (f)(2)(i)(C) may be disclosed with greater prominence than the other information.

(3) *Disclosure of payments*—(i) *In general.* In addition to the requirements of paragraph (c) of this section, if an advertisement for credit secured by a dwelling states the amount of any payment, the advertisement shall disclose in a clear and conspicuous manner:

(A) The amount of each payment that will apply over the term of the loan, including any balloon payment. In variable-rate transactions, payments that will be determined based on the application of the sum of an index and margin shall be disclosed based on a reasonably current index and margin;

(B) The period of time during which each payment will apply; and

(C) In an advertisement for credit secured by a first lien on a dwelling, the fact that the payments do not include amounts for taxes and insurance premiums, if applicable, and that the actual payment obligation will be greater.

(ii) *Clear and conspicuous requirement.* For purposes of paragraph (f)(3)(i) of this section, a clear and conspicuous disclosure means that the required information in paragraphs (f)(3)(i)(A) and (B) shall be disclosed with equal prominence and in close proximity to any advertised payment that triggered the required disclosures, and that the required information in paragraph (f)(3)(i)(C) shall be disclosed with prominence and in close proximity to the advertised payments.

(4) *Envelope excluded.* The requirements in paragraphs (f)(2) and (f)(3) of this section do not apply to an envelope in which an application or solicitation is mailed, or to a banner advertisement or pop-up advertisement linked to an application or solicitation provided electronically.

(g) *Alternative disclosures—television or radio advertisements.* An advertisement made through television or radio stating orally any of the terms requiring additional disclosures under paragraph (d)(2) of this section may comply with paragraph (d)(2) of this section either by:

(1) Stating orally each of the additional disclosures required under paragraph (d)(2) of this section at a speed and volume sufficient for a consumer to hear and comprehend them; or

(2) Stating orally the information required by paragraph (d)(2)(iii) of this section at a speed and volume sufficient for a consumer to hear and comprehend them, and listing a toll-free telephone number along with a reference that such number may be used by consumers to obtain additional cost information.

(h) *Tax implications.* If an advertisement distributed in paper form or through the Internet (rather than by radio or television) is for a loan secured by the consumer's principal dwelling, and the advertised extension of credit may, by its terms, exceed the fair market value of the dwelling, the advertisement shall clearly and conspicuously state that:

(1) The interest on the portion of the credit extension that is greater than the fair market value of the dwelling is not tax deductible for Federal income tax purposes; and

(2) The consumer should consult a tax adviser for further information regarding the deductibility of interest and charges.

(i) *Prohibited acts or practices in advertisements for credit secured by a dwelling.* The following acts or practices are prohibited in advertisements for credit secured by a dwelling:

(1) *Misleading advertising of ''fixed'' rates and payments.* Using the word ''fixed'' to refer to rates, payments, or the credit transaction in an advertisement for variable-rate transactions or other transactions where the advertised payment may increase, unless:

(i) In the case of an advertisement solely for one or more variable-rate transactions,

(A) The phrase ''Adjustable-Rate Mortgage'' or ''Variable-Rate Mortgage'' appears in the advertisement before the first use of the word ''fixed'' and is at least as conspicuous as every use of the word ''fixed'' in the advertisement; and

(B) Each use of the word ''fixed'' to refer to a rate or payment is accompanied by an equally prominent and closely proximate statement of the time period for which the rate or payment is fixed, and the fact that the rate may vary or the payment may increase after that period;

(ii) In the case of an advertisement solely for transactions other than variable-rate transactions where the advertised payment may increase (*e.g.*, a fixed-rate mortgage transaction with an initial lower payment), each use of the word ''fixed'' to refer to the advertised payment is accompanied by an equally prominent and closely proximate statement of the time period for which the payment is fixed, and the fact that the payment may increase after that period; or

(iii) In the case of an advertisement for both variable-rate transactions and non-variable-rate transactions,

(A) The phrase ''Adjustable-Rate Mortgage,'' ''Variable-Rate Mortgage,'' or ''ARM'' appears in the advertisement with equal prominence as any use of the term ''fixed,'' ''Fixed-Rate Mortgage,'' or similar terms; and

(B) Each use of the word ''fixed'' to refer to a rate, payment, or the credit transaction either refers solely to the transactions for which rates are fixed and complies with paragraph (i)(1)(ii) of this section, if applicable, or, if it refers

to the variable-rate transactions, is accompanied by an equally prominent and closely proximate statement of the time period for which the rate or payment is fixed, and the fact that the rate may vary or the payment may increase after that period.

(2) *Misleading comparisons in advertisements.* Making any comparison in an advertisement between an actual or hypothetical consumer's current credit payments or rates and any payment or simple annual rate that will be available under the advertised product for less than the term of the loan, unless:

(i) *In general.* The advertisement includes:

(A) An equally prominent, closely proximate comparison to all applicable payments or rates for the advertised product that will apply over the term of the loan and an equally prominent, closely proximate statement of the period of time for which each applicable payment or rate applies; and

(B) A prominent statement in close proximity to the payments described in paragraph (i)(2)(i)(A) of this section that the advertised payments do not include amounts for taxes and insurance premiums, if applicable; or

(ii) *Application to variable-rate transactions.* If the advertisement is for a variable-rate transaction, and the advertised payment or simple annual rate is based on the index and margin that will be used to make subsequent rate or payment adjustments over the term of the loan, the advertisement includes:

(A) An equally prominent statement in close proximity to the payment or rate that the payment or rate is subject to adjustment and the time period when the first adjustment will occur; and

(B) A prominent statement in close proximity to the advertised payment that the payment does not include amounts for taxes and insurance premiums, if applicable.

(3) *Misrepresentations about government endorsement.* Making any statement in an advertisement that the product offered is a ''government loan program'', ''government-supported loan'', or is otherwise endorsed or sponsored by any federal, state, or local government entity, unless the advertisement is for an FHA loan, VA loan, or similar loan program that is, in fact, endorsed or sponsored by a federal, state, or local government entity.

(4) *Misleading use of the current lender's name.* Using the name of the consumer's current lender in an advertisement that is not sent by or on behalf of the consumer's current lender, unless the advertisement:

(i) Discloses with equal prominence the name of the person or creditor making the advertisement; and

(ii) Includes a clear and conspicuous statement that the person making the advertisement is not associated with, or acting on behalf of, the consumer's current lender.

(5) *Misleading claims of debt elimination.* Making any claim in an advertisement that the mortgage product offered will eliminate debt or result in a waiver or forgiveness of a consumer's existing loan terms with, or obligations to, another creditor.

(6) *Misleading claims suggesting a fiduciary or other relationship.* Using the terms ''counselor'' or ''financial advisor'' in an advertisement to refer to a for-profit mortgage broker or mortgage lender, its employees, or persons working for the broker or lender that are involved in offering, originating or selling mortgages.

(7) *Misleading foreign-language advertisements.* Providing information about some trigger terms or required disclosures, such as an initial rate or payment, only in a foreign language in an advertisement, but providing information about other trigger terms or required disclosures, such as information about the fully-indexed rate or fully amortizing payment, only in English in the same advertisement.◄

Subpart E—Special Rules for Certain Home Mortgage Transactions

7. Section 226.32 is amended by revising paragraph (d)(7) to read as follows:

§ 226.32 Requirements for certain closed-end home mortgages.

* * * * *

(d) * * *

(7) *Prepayment penalty exception.* A mortgage transaction subject to this section may provide for a prepayment penalty otherwise permitted by law (including a refund calculated according to the rule of 78s) if:

(i) The penalty can be exercised only for the first five years following consummation;

(ii) The source of the prepayment funds is not a refinancing by the creditor or an affiliate of the creditor; **[**and**]**

(iii) At consummation, the consumer's total monthly ►debt payments◄ **[**debts**]** (including amounts owed under the mortgage) do not exceed 50 percent of the consumer's monthly gross income, as verified ►in accordance with § 226.35(b)(2)(i); and◄ **[**by the consumer's signed financial statement, a credit report, and payment records for employment income.**]**

►(iv) The penalty period ends at least sixty days prior to the first date, if any, on which the principal or interest payment amount may increase under the terms of the loan.◄

* * * * *

8. Section 226.34 is amended by revising the heading and paragraph (a)(4) to read as follows:

§ 226.34 Prohibited acts or practices in connection with credit [secured by a consumer's dwelling] ►subject to § 226.32◄.

(a) * * *

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

►(4) *Repayment ability.* Engage in a pattern or practice of extending credit subject to § 226.32 to consumers based on the value of consumers' collateral without regard to consumers' repayment ability as of consummation, including consumers' current and reasonably expected income, current and reasonably expected obligations, employment, and assets other than the collateral.

(i) There is a presumption that a creditor has violated this paragraph (a)(4) if the creditor engages in a pattern or practice of failing to—

(A) Verify and document consumers' repayment ability in accordance with § 226.35(b)(2)(i);

(B) Consider consumers' ability to make loan payments based on the interest rate, determined as follows in the case of a loan in which the interest rate may increase after consummation—

(*1*) For a variable rate loan, the interest rate as determined by adding the margin and the index value as of consummation, or the initial rate if that rate is greater than the sum of the index value and margin as of consummation; and

(*2*) For a step-rate loan, the highest interest rate possible within the first seven years of the loan's term;

(C) Consider consumers' ability to make loan payments based on a fully-amortizing payment that includes, as applicable: expected property taxes; homeowners' association dues; premiums for insurance against loss of or damage to property, or against

liability arising out of the ownership or use of the property; premiums for any guarantee or insurance protecting the creditor against consumers' default or other credit loss; and premiums for other mortgage related insurance;

(D) Consider the ratio of consumers' total debt obligations to consumers' income; or

(E) Consider the income consumers will have after paying debt obligations.

(ii) A creditor does not violate this paragraph (a)(4) if it has a reasonable basis to believe consumers will be able to make loan payments for at least seven years after consummation of the transaction, considering the factors identified in paragraph (a)(4)(i) of this section and any other factors relevant to determining repayment ability.

(iii) This paragraph (a)(4) does not apply to temporary or ''bridge'' loans with terms of twelve months or less, such as a loan to purchase a new dwelling where the consumer plans to sell a current dwelling within twelve months.◄

* * * * *

9. New § 226.35 is added to read as follows:

►§ 226.35 Prohibited acts or practices in connection with higher-priced mortgage loans.

(a) *Higher-priced mortgage loans.* (1) For purposes of this section, a higher-priced mortgage loan is a consumer credit transaction that is secured by the consumer's principal dwelling in which the annual percentage rate at consummation will exceed the yield on comparable Treasury securities by three or more percentage points for loans secured by a first lien on a dwelling, or by five or more percentage points for loans secured by a subordinate lien on a dwelling.

(2) Comparable Treasury securities are determined as follows for variable rate loans:

(i) For a loan with an initial rate that is fixed for more than one year, securities with a maturity matching the duration of the fixed-rate period, unless the fixed-rate period exceeds seven years, in which case the creditor should use the rules applied to non-variable rate loans; and

(ii) For all other loans, securities with a maturity of one year.

(3) Comparable Treasury securities are determined as follows for non-variable rate loans:

(i) For a loan with a term of twenty years or more, securities with a maturity of ten years;

(ii) For a loan with a term of more than seven years but less than twenty years, securities with a maturity of seven years; and

(iii) For a loan with a term of seven years or less, securities with a maturity matching the term of the transaction.

(4) The creditor shall use the yield on Treasury securities as of the 15th day of the preceding month if the creditor receives the application between the 1st and the 14th day of the month and as of the 15th day of the current month if the creditor receives the application on or after the 15th day.

(5) Notwithstanding paragraph (a)(1) of this section, a higher-priced mortgage loan excludes a transaction to finance the initial construction of a dwelling, a temporary or ''bridge'' loan with a term of twelve months or less, such as a loan to purchase a new dwelling where the consumer plans to sell a current dwelling within twelve months, a reverse-mortgage transaction subject to § 226.33, or a home equity line of credit subject to § 226.5b.

(b) *Rules for higher-priced mortgage loans.* Higher-priced mortgage loans are subject to the following restrictions:

(1) *Repayment ability.* A creditor shall not engage in a pattern or practice of extending credit as provided in § 226.34(a)(4).

(2) *Verification of income and assets relied on.* (i) A creditor shall not rely on amounts of income, including expected income, or assets in approving an extension of credit unless the creditor verifies such amounts by the consumer's Internal Revenue Service Form W–2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income or assets.

(ii) A creditor has not violated paragraph (b)(2)(i) of this section if the amounts of income and assets that the creditor relied upon in approving the transaction are not materially greater than the amounts of the consumer's income or assets that the creditor could have verified pursuant to paragraph (b)(2)(i) of this section at the time the loan was consummated.

(3) *Prepayment penalties.* A loan shall not include a prepayment penalty provision except under the conditions provided in § 226.32(d)(7).

(4) *Failure to escrow for property taxes and insurance.* Prior to or at consummation of a loan secured by a first lien on a dwelling, an escrow account must be established for payment of property taxes; premiums for insurance against loss of or damage to property, or against liability arising out of the ownership or use of the property; premiums for any guarantee or insurance protecting the creditor against the consumer's default or other credit loss; and premiums for other mortgage-related insurance.

(i) A creditor may permit a consumer to cancel the escrow account required in paragraph (b)(4) only in response to a consumer's dated written request to cancel the escrow account that is received no earlier than twelve months after consummation.

(ii) For purposes of this section, ''escrow account'' shall have the same meaning as in 24 CFR 3500.17(b) as amended.

(5) *Evasion; open-end credit.* In connection with credit secured by a consumer's principal dwelling that does not meet the definition of open-end credit in § 226.2(a)(20), a creditor shall not structure a home-secured loan as an open-end plan to evade the requirements of this section.◄

10. New § 226.36 is added to read as follows:

►§ 226.36 Prohibited acts or practices in connection with credit secured by a consumer's principal dwelling.

(a) *Creditor payments to mortgage brokers.* (1) In connection with a consumer credit transaction secured by a consumer's principal dwelling, except as provided in paragraph (a)(2) of this section, a creditor shall not make any payment, directly or indirectly, to a mortgage broker unless the broker enters into a written agreement with the consumer that satisfies the conditions set forth in this paragraph (a)(1). A creditor payment to a mortgage broker subject to this paragraph (a)(1) shall not exceed the total compensation amount stated in the written agreement, reduced by any amounts paid directly by the consumer or by any other source. The written agreement must be entered into before the consumer pays a fee to any person in connection with the mortgage transaction or submits a written application to the broker for the transaction, whichever is earlier. The written agreement must include a clear and conspicuous statement—

(i) Of the total amount of compensation the mortgage broker will receive and retain from all sources, as a dollar amount;

(ii) That the consumer will pay the entire amount of compensation that the mortgage broker will receive and retain, even if all or part is paid directly by the creditor, because the creditor recovers such payments through a higher interest rate; and

(iii) That creditor payments to a mortgage broker can influence the broker to offer certain loan products or terms to the consumer that are not in the consumer's interest or are not the most

favorable the consumer otherwise could obtain.

(2) Paragraph (a)(1) of this section does not apply to a transaction—

(i) That is subject to a state statute or regulation that expressly imposes a duty on mortgage brokers, under which a mortgage broker may not offer to consumers loan products or terms that are not in consumers' interest or are less favorable than consumers otherwise could obtain, and that requires that a mortgage broker provide consumers with a written agreement that includes a description of the mortgage broker's role in the transaction and the mortgage broker's relationship to the consumer, as defined by such statute or regulation; or

(ii) Where the creditor can demonstrate that the compensation it pays to a mortgage broker in connection with a transaction is not determined, in whole or in part, by reference to the transaction's interest rate.

(b) *Misrepresentation of value of consumer's dwelling*—(1) *Coercion of appraiser.* In connection with a consumer credit transaction secured by a consumer's principal dwelling, no creditor or mortgage broker, and no affiliate of a creditor or mortgage broker shall directly or indirectly coerce, influence, or otherwise encourage an appraiser to misstate or misrepresent the value of such dwelling.

(i) Examples of actions that violate paragraph (b)(1) of this section include:

(A) Implying to an appraiser that current or future retention of the appraiser depends on the amount at which the appraiser values a consumer's principal dwelling;

(B) Failing to compensate an appraiser because the appraiser does not value a consumer's principal dwelling at or above a certain amount; and

(C) Conditioning an appraiser's compensation on loan consummation.

(ii) Examples of actions that do not violate this subsection include:

(A) Asking an appraiser to consider additional information about a consumer's principal dwelling or about comparable properties;

(B) Requesting that an appraiser provide additional information about the basis for a valuation;

(C) Requesting that an appraiser correct factual errors in a valuation;

(D) Obtaining multiple appraisals of a consumer's principal dwelling, so long as the creditor adheres to a policy of selecting the most reliable appraisal, rather than the appraisal that states the highest value;

(E) Withholding compensation from an appraiser for breach of contract or substandard performance of services as provided by contract;

(F) Terminating a relationship with an appraiser for violations of applicable federal or state law or breaches of ethical or professional standards; and

(G) Taking action permitted or required by applicable federal or state statute, regulation, or agency guidance.

(2) *When extension of credit prohibited.* In connection with a consumer credit transaction secured by a consumer's principal dwelling, a creditor who knows or has reason to know, at or before loan consummation, of a violation of § 226.36(b)(1) in connection with an appraisal shall not extend credit based on such appraisal unless the creditor documents that it has acted with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of such dwelling.

(3) *Appraiser defined.* As used in this paragraph (b), an appraiser is a person who engages in the business of providing assessments of the value of dwellings. The term ''appraiser'' includes persons that employ, refer, or manage appraisers and affiliates of such persons.

(c) *Mortgage broker defined.* For purposes of this section, the term ''mortgage broker'' means a person, other than an employee of a creditor, who for compensation or other monetary gain, or in expectation of compensation or other monetary gain, arranges, negotiates, or otherwise obtains an extension of consumer credit. The term includes a person meeting this definition, even if the consumer credit obligation is initially payable to such person, unless the person provides the funds for the transaction at consummation out of the person's own resources, out of deposits held by the person, or by drawing on a bona fide warehouse line of credit.

(d) *Servicing practices.* (1) In connection with a consumer credit transaction secured by a consumer's principal dwelling, no servicer shall—

(i) Fail to credit a payment to the consumer's loan account as of the date of receipt, except when a delay in crediting does not result in any charge to the consumer or in the reporting of negative information to a consumer reporting agency, or except as provided in paragraph (d)(2) of this section;

(ii) Impose on the consumer any late fee or delinquency charge in connection with a payment, when the only delinquency is attributable to late fees or delinquency charges assessed on an earlier payment, and the payment is otherwise a full payment for the applicable period and is paid on its due date or within an applicable grace period;

(iii) Fail to provide to the consumer within a reasonable time after receiving a consumer's request a schedule of all specific fees and charges that the servicer may impose on the consumer in connection with servicing the consumer's account, including a dollar amount and an explanation of each such fee and the circumstances under which it is imposed; or

(iv) Fail to provide, within a reasonable time after receiving a request from the consumer or any person acting on behalf of the consumer, an accurate statement of the total outstanding balance of the consumer's obligation that would be required to satisfy the obligation in full as of a specified date.

(2) If a servicer specifies in writing requirements for the consumer to follow in making payments, but accepts a payment that does not conform to the requirements, the servicer shall credit the payment within 5 days of receipt.

(3) For purposes of this paragraph (d), the terms ''servicer'' and ''servicing'' have the same meanings as provided in 24 CFR 3500.2(b), as amended.

(e) This section does not apply to a home equity line of credit subject to § 226.5b.◀

11. In Supplement I to Part 226:

a. Under *Section 226.2—Definitions and Rules of Construction, 2(a) Definitions, 2(a)(24) Residential Mortgage Transaction,* paragraphs 2(a)(24)–1 and 2(a)(24)–5 are revised.

b. Under *Section 226.16—Advertising:*

i. Paragraph 16–1 is revised, paragraph 16–2 is redesignated as paragraph 16–6, and new paragraphs 16–2 through 16–5 are added.

ii. Under *16(d) Additional requirements for home equity plans,* paragraph 16(d)–3 is revised, paragraphs 16(d)–5, 16(d)–6, and 16(d)–7 are redesignated as paragraphs 16(d)–7, 16(d)–8, and 16(d)–9 respectively, newly designated paragraphs 16(d)–7 and 16(d)–9 and the heading of newly designated paragraph 16(d)–8 are revised, and new paragraphs 16(d)–5 and 16(d)–6 are added.

c. Under *Section 226.17—General Disclosure Requirements, 17(c) Basis of disclosures and use of estimates, Paragraph 17(c)(1),* paragraph 17(c)(1)–8 is revised, and under *17(f) Early disclosures,* paragraph 17(f)–4 is revised.

d. Under *Section 226.19—Certain Residential Mortgage and Variable-Rate Transactions,* the heading is revised, heading *19(a)(1) Time of disclosure* is redesignated as heading *19(a)(1)(i) Time of disclosure,* paragraphs 19(a)(1)(i)–1 and 19(a)(1)(i)–5 are revised, new headings *19(a)(1)(ii) Imposition of fees* and *19(a)(1)(iii) Exception to fee*

restriction are added, and new paragraphs 19(a)(1)(ii)–1, 19(a)(1)(ii)–2, and 19(a)(1)(iii)–1 are added.

e. Under *Section 226.24—Advertising:*

i. Paragraph 24–1 is removed;

ii. Heading *24(d) Catalogues or other multiple-page advertisements; electronic advertisements* is redesignated as *24(e) Catalogues or other multiple-page advertisements; electronic advertisements,* and newly designated paragraphs 24(e)–1, 24(e)–2, and 24(e)–4 are revised;

iii. Headings *24(c) Advertisement of terms that require additional disclosures, Paragraph 24(c)(1),* and *Paragraph 24(c)(2),* are redesignated as *24(d) Advertisement of terms that require additional disclosures, Paragraph 24(d)(1),* and *Paragraph 24(d)(2)* respectively, newly designated paragraphs 24(d)–1, 24(d)(1)–3, and 24(d)(2)–2 are revised, newly designated paragraphs 24(d)(2)–3 and 24(d)(2)–4 are further redesignated as paragraphs 24(d)(2)–4 and 24(d)(2)–5 respectively, new paragraph 24(d)(2)–3 is added, and newly designated paragraph 24(d)(2)–5 is revised;

iv. Heading *24(b) Advertisement of rate of finance charge* is redesignated as *24(c) Advertisement of rate of finance charge,* and newly designated paragraphs 24(c)–2 and 24(c)–3 are revised, newly designated paragraph 24(c)–4 is removed, newly designated paragraph 24(c)–5 is redesignated as paragraph 24(c)–4 and revised, and newly designated paragraph 24(c)–6 is further redesignated as paragraph 24(c)–5.

v. New heading *24(b) Clear and conspicuous standard* is added, and new paragraphs 24(b)–1 through 24(b)–5 are added; and

vi. New headings *24(f) Disclosure of rates or payments in advertisements for credit secured by a dwelling, 24(f)(3) Disclosure of payments, 24(g) Alternative disclosures—television or radio advertisements, 24(h) Statements of tax deductibility, and 24(i) Prohibited acts or practices in advertisements for credit secured by a dwelling,* and new paragraphs 24(f)–1 through 24(f)–5, 24(f)(3)–1 and 24(f)(3)–2, 24(g)–1 through 24(g)–3, 24(h)–1, and 24(i)–1 through 24(i)–3 are added.

f. Under *Section 226.32—Requirements for Certain Closed-End Home Mortgages, 32(a) Coverage:*

i. New heading *Paragraph 32(a)(2)* and new paragraph 32(a)(2)–1 are added.

ii. Under *32(d) Limitations,* new paragraph 32(d)–1 is added.

iii. Under *32(d)(7) Prepayment penalty exception,* new paragraph 32(d)(7)–1 is added.

iv. Under *Paragraph 32(d)(7)(iii),* paragraphs 32(d)(7)(iii)–1 and 32(d)(7)(iii)–2 are removed, and new paragraphs 32(d)(7)(iii)–1 through 32(d)(7)(iii)–4 are added.

v. New heading *Paragraph 32(d)(7)(iv)* and new paragraphs 32(d)(7)(iv)–1 and 32(d)(7)(iv)–2 are added.

g. Under *Section 226.34—Prohibited Acts or Practices in Connection with Credit Secured by a Consumer's Dwelling; Open-end Credit:*

i. The heading is revised.

ii. Under *34(a) Prohibited acts or practices for loans subject to § 226.32, 34(a)(4) Repayment ability,* paragraphs 34(a)(4)–3 and 34(a)(4)–4 are removed, paragraphs 34(a)(4)–1 and 34(a)(4)–2 are redesignated as paragraphs 34(a)(4)–3 and 34(a)(4)–4 respectively and revised, new paragraphs 34(a)(4)–1 and 34(a)(4)–2 are added, and new headings *Paragraph 34(a)(4)(i), Paragraph 34(a)(4)(i)(A), Paragraph 34(a)(4)(i)(B), Paragraph 34(a)(4)(i)(D),* and *Paragraph 34(a)(4)(i)(E)* and new paragraphs 34(a)(4)(i)–1, 34(a)(4)(i)(A)–1 and 34(a)(4)(i)(A)–2, 34(a)(4)(i)(B)–1, 34(a)(4)(i)(D)–1, and 34(a)(4)(i)(E)–1 are added.

h. A new *Section 226.35—Prohibited Acts or Practices in Connection with Higher-priced Mortgage Loans* is added.

i. A new *Section 226.36—Prohibited Acts or Practices in Connection with Credit Secured by a Consumer's Principal Dwelling* is added.

Supplement I to Part 226—Official Staff Interpretations

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Subpart A—General

* * * * *

Section 226.2—Definitions and Rules of Construction

2(a) Definitions.

* * * * *

2(a)(24) Residential mortgage transaction.

1. *Relation to other sections.* This term is important in [six] ►five◄ provisions in the regulation:

[•] ►i.◄ § 226.4(c)(7)—exclusions from the finance charge.

[•] ►ii.◄ § 226.15(f)—exemption from the right of rescission.

[•] ►iii.◄ § 226.18(q)—whether or not the obligation is assumable.

[• Section 226.19—special timing rules.]

[•] ►iv.◄ § 226.20(b)—disclosure requirements for assumptions.

[•] ►v.◄ § 226.23(f)—exemption from the right of rescission.

* * * * *

5. *Acquisition.* i. A residential mortgage transaction finances the acquisition of a consumer's principal dwelling. The term does not include a transaction involving a consumer's principal dwelling if the consumer had previously purchased and acquired some interest to the dwelling, even though the consumer had not acquired full legal title.

ii. Examples of new transactions involving a previously acquired dwelling include the financing of a balloon payment due under a land sale contract and an extension of credit made to a joint owner of property to buy out the other joint owner's interest. In these instances, disclosures are not required under § 226.18(q) [or section 226.19(a)] (assumability policies [and early disclosures for residential mortgage transactions]). However, the rescission rules of §§ 226.15 and 226.23 do apply to these new transactions.

iii. In other cases, the disclosure and rescission rules do not apply. For example, where a buyer enters into a written agreement with the creditor holding the seller's mortgage, allowing the buyer to assume the mortgage, if the buyer had previously purchased the property and agreed with the seller to make the mortgage payments, § 226.20(b) does not apply (assumptions involving residential mortgages).

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Subpart B—Open-End Credit

* * * * *

Section 226.16—Advertising

1. *Clear and conspicuous standard►—general◄.* Section 226.16 is subject to the general ''clear and conspicuous'' standard for subpart B (see § 226.5(a)(1)) but prescribes no specific rules for the format of the necessary disclosures[.]►, aside from the format requirements related to the disclosure of an introductory rate under §§ 226.16(d)(6) and 226.16(e). Aside from the terms described in §§ 226.16(d)(6) and 226.16(e), the◄ [The] credit terms need not be printed in a certain type size nor need they appear in any particular place in the advertisement.

►2. *Clear and conspicuous standard-introductory rates or payments for home—equity plans.* For purposes of § 226.16(d)(6), a clear and conspicuous disclosure means that the required information in § 226.16(d)(6)(iii)(A)–(C) is disclosed with equal prominence and in close proximity to the introductory rate or payment to which it applies. If the information in § 226.16(d)(6)(iii)(A)–(C) is the same type size and is located immediately next to or directly above or below the introductory rate or payment to which it applies, without any intervening text or graphical displays, the disclosures would be deemed to be equally prominent and in close proximity. Notwithstanding the above, for electronic advertisements that disclose introductory rates or payments, compliance with the requirements of § 226.16(c) is deemed to satisfy the clear and conspicuous standard.

3. *Clear and conspicuous standard—Internet advertisements for home-equity plans.* For purposes of this section, a clear and conspicuous disclosure for visual text advertisements on the Internet for home-equity plans subject to the requirements of § 226.5b means that the required disclosures are not obscured by techniques such as graphical displays, shading, coloration, or

other devices and comply with all other requirements for clear and conspicuous disclosures under § 226.16(d). *See also* comment 16(c)(1)–2.

4. *Clear and conspicuous standard—televised advertisements for home-equity plans.* For purposes of this section, and except as otherwise provided by § 226.16(f) for alternative disclosures, a clear and conspicuous disclosure in the context of visual text advertisements on television for home-equity plans subject to the requirements of § 226.5b means that the required disclosures are not obscured by techniques such as graphical displays, shading, coloration, or other devices, are displayed in a manner that allows for a consumer to read the information required to be disclosed, and comply with all other requirements for clear and conspicuous disclosures under § 226.16(d). For example, very fine print in a television advertisement would not meet the clear and conspicuous standard if consumers cannot see and read the information required to be disclosed.

5. *Clear and conspicuous standard—oral advertisements for home-equity plans.* For purposes of this section, and except as otherwise provided by § 226.16(f) for alternative disclosures, a clear and conspicuous disclosure in the context of an oral advertisement for home-equity plans subject to the requirements of § 226.5b, whether by radio, television, the Internet, or other medium, means that the required disclosures are given at a speed and volume sufficient for a consumer to hear and comprehend them. For example, information stated very rapidly at a low volume in a radio or television advertisement would not meet the clear and conspicuous standard if consumers cannot hear and comprehend the information required to be disclosed.◄

►6.◄ [2.] *Expressing the annual percentage rate in abbreviated form.* * * *

* * * * *

16(d) Additional requirements for home-equity plans.

* * * * *

3. *Statements of tax deductibility.* An advertisement referring to deductibility for tax purposes is not misleading if it includes a statement such as ''consult a tax advisor regarding the deductibility of interest.'' ►An advertisement for a home-equity plan where the plan's terms do not allow for extensions of credit greater than the fair market value of the consumer's dwelling need not give the disclosures regarding which portion of the interest is tax deductible. An advertisement for such a plan is not required to refer to deductibility for tax purposes; however, if it does so, it must not be misleading in this regard.◄

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►5. *Introductory rates and payments in advertisements for home-equity plans.* Section 226.16(d)(6) requires additional disclosures for introductory rates or payments.

i. *Variable-rate plans.* In advertisements for variable-rate plans, if the advertised annual percentage rate is based on (or the advertised payment is derived from) the index and margin that will be used to make rate (or payment) adjustments over the term of the loan, then there is no introductory rate or introductory payment. If, however, the advertised annual percentage rate is not based on (or the advertised payment is not derived from) the index and margin that will be used to make rate (or payment) adjustments, and a reasonably current application of the index and margin would result in a higher annual percentage rate (or, given an assumed balance, a higher payment) then there is an introductory rate or introductory payment.

ii. *Immediate proximity.* Including the term ''introductory'' or ''intro'' in the same sentence as the listing of the introductory rate or payment is deemed to be in immediate proximity of the listing.

iii. *Equal prominence, close proximity.* Information required to be disclosed in § 226.16(d)(6)(iii) that is in the same paragraph as the introductory rate or payment (not in a footnote to that paragraph) is deemed to be closely proximate to the listing. Information required to be disclosed in § 226.16(d)(6)(iii) that is in the same type size as the introductory rate or payment is deemed to be equally prominent.

iv. *Amounts and time periods of payments.* Section 226.16(d)(6)(iii)(C) requires disclosure of the amount and time periods of any payments that will apply under the plan. This section may require disclosure of several payment amounts, including any balloon payment. For example, if an advertisement for a home-equity plan offers a $100,000 five-year line of credit and assumes that the entire line is drawn resulting in a payment of $800 per month for the first six months, increasing to $1,000 per month after month six, followed by a $50,000 balloon payment after five years, the advertisement must disclose the amount and time period of each of the two monthly payment streams, as well as the amount and timing of the balloon payment, with equal prominence and in close proximity to the introductory payment.

v. *Plans other than variable-rate plans.* For a plan other than a variable-rate plan, if an advertised payment is calculated in the same way as other payments based on an assumed balance, the fact that the payment could increase solely if the consumer made an additional draw does not make the payment an introductory payment. For example, if a payment of $500 results from an assumed $10,000 draw, and the payment would increase to $1000 if the consumer made an additional $10,000 draw, the payment is not an introductory payment.

6. *Reasonably current index and margin.* For the purposes of this section, an index and margin is considered reasonably current if:

i. For direct mail advertisements, it was in effect within 60 days before mailing;

ii. For advertisements in electronic form, it was in effect within 30 days before the advertisement is sent to a consumer's e-mail address, or in the case of an advertisement made on an Internet Web site, when viewed by the public; or

iii. For printed advertisements made available to the general public, including ones contained in a catalog, magazine, or other generally available publication, it was in effect within 30 days before printing.

7.◄[5.] *Relation to other sections.* Advertisements for home-equity plans must comply with all provisions in § 226.16, ►except for § 226.16(e),◄ not solely the rules in § 226.16(d). If an advertisement contains information (such as the payment terms) that triggers the duty under § 226.16(d) to state the annual percentage rate, the additional disclosures in § 226.16(b) must be provided in the advertisement. While § 226.16(d) does not require a statement of fees to use or maintain the plan (such as membership fees and transaction charges), such fees must be disclosed under § 226.16(b)(1) and (3).

►8.◄[6.] *Inapplicability of closed-end rules.* * * *

►9.◄[7.] *Balloon payment.* [In some programs, a balloon payment will occur if only the minimum payments under the plan are made. If an advertisement for such a program contains any statement about a minimum periodic payment, the advertisement must also state that a balloon payment will result (not merely that a balloon payment ''may'' result). (]See comment 5b(d)(5)(ii)–3 for [guidance on items] ►information◄ not required to be stated in [the] advertisement►s◄, and on situations in which the balloon payment requirement does not apply.[)]

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Subpart C—Closed-End Credit

Section 226.17—General Disclosure Requirements

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17(c) Basis of disclosures and use of estimates.

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Paragraph 17(c)(1).

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8. *Basis of disclosures in variable-rate transactions.* The disclosures for a variable-rate transaction must be given for the full term of the transaction and must be based on the terms in effect at the time of consummation. Creditors should base the disclosures only on the initial rate and should not assume that this rate will increase. For example, in a loan with an initial rate of 10 percent and a 5 percentage points rate cap, creditors should base the disclosures on the initial rate and should not assume that this rate will increase 5 percentage points. However, in a variable-rate transaction with a seller buydown that is reflected in the credit contract, a consumer buydown, or a discounted or premium rate, disclosures should not be based solely on the initial terms. In those transactions, the disclosed annual percentage rate should be a composite rate based on the rate in effect during the initial period and the rate that is the basis of the variable-rate feature for the remainder of the term. (See the commentary to § 226.17(c) for a discussion of buydown, discounted, and premium transactions and the commentary to § 226.19(a)(2) for a discussion of the redisclosure in certain [residential] mortgage transactions with a variable-rate feature).

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17(f) Early disclosures.

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4. *Special rules*. In [residential] mortgage transactions subject to § 226.19, the creditor must redisclose if, between the delivery of the required early disclosures and consummation, the annual percentage rate changes by more than a stated tolerance. When subsequent events occur after consummation, new disclosures are required only if there is a refinancing or an assumption within the meaning of § 226.20.

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Section 226.19—Certain [Residential] Mortgage and Variable-Rate Transactions

19(a)(1)►(i)◄ Time of disclosure.

1. *Coverage*. This section requires early disclosure of credit terms in [residential] mortgage transactions that are ►secured by a consumer's principal dwelling and◄ also subject to the Real Estate Settlement Procedures Act (RESPA) and its implementing Regulation X, administered by the Department of Housing and Urban Development (HUD). To be covered by § 226.19, a transaction must be [both a residential mortgage transaction under section 226.2(a) and] a federally related mortgage loan under RESPA. ''Federally related mortgage loan'' is defined under RESPA (12 U.S.C. 2602) and Regulation X (24 CFR 3500.[5(b)]►2◄), and is subject to any interpretations by HUD.► RESPA coverage includes such transactions as loans to purchase dwellings, refinancings of loans secured by dwellings, and subordinate-lien home-equity loans, among others. Although RESPA coverage relates to any dwelling, § 226.19(a) applies to such transactions only if they are secured by a consumer's principal dwelling. Also, home equity lines of credit subject to § 226.5b are not covered by § 226.19(a).◄

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5. *Itemization of amount financed*. In many [residential] mortgage transactions, the itemization of the amount financed required by § 226.18(c) will contain items, such as origination fees or points, that also must be disclosed as part of the good faith estimates of settlement costs required under RESPA. Creditors furnishing the RESPA good faith estimates need not give consumers any itemization of the amount financed, either with the disclosures provided within three days after application or with the disclosures given at consummation or settlement.

►*19(a)(1)(ii) Imposition of fees.*

1. *Timing of fees*. The consumer must receive the disclosures required by this section before paying any fee to a creditor or other person in connection with the consumer's application for a mortgage transaction that is subject to § 226.19(a)(1)(i), except as provided in § 226.19(a)(1)(iii). If the creditor delivers the disclosures to the consumer in person, a fee may be imposed anytime after delivery. If the creditor places the disclosures in the mail, the creditor may impose a fee after the consumer receives the disclosures or, in all cases, on or after the fourth business day after mailing the disclosure.

2. *Fees restricted*. A creditor or other person may not charge any fee other than to obtain a consumer's credit history, such as for a credit report(s), until the consumer has received the disclosures required by § 226.19(a)(1)(i). For example, until the consumer has received the disclosures, the creditor may not impose a fee on the consumer for an appraisal or for underwriting.

19(a)(1)(iii) Exception to fee restriction.

1. *Requirements for exception*. A creditor or other person may impose a fee before the consumer receives the required disclosures if it is for obtaining information on the consumer's credit history, such as by purchasing a credit report(s) on the consumer. The fee also must be *bona fide* and reasonable in amount. For example, a creditor may collect a fee for obtaining a credit report(s) if it is the creditor's ordinary practice to obtain such credit history information. The creditor may refer to this fee as an ''application fee.''◄

* * * * *

Section 226.24—Advertising

[1. *Clear and conspicuous standard*. This section is subject to the general ''clear and conspicuous'' standard for this subpart but prescribes no specific rules for the format of the necessary disclosures. The credit terms need not be printed in a certain type size nor need they appear in any particular place in the advertisement. For example, a merchandise tag that is an advertisement under the regulation complies with this section if the necessary credit terms are on both sides of the tag, so long as each side is accessible.]

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►*24(b) Clear and conspicuous standard.*

1. *Clear and conspicuous standard—general*. This section is subject to the general ''clear and conspicuous'' standard for this subpart, *see* § 226.17(a)(1), but prescribes no specific rules for the format of the necessary disclosures, other than the format requirements related to the advertisement of rates and payments as described in comment 24(b)–2 below. The credit terms need not be printed in a certain type size nor need they appear in any particular place in the advertisement. For example, a merchandise tag that is an advertisement under the regulation complies with this section if the necessary credit terms are on both sides of the tag, so long as each side is accessible.

2. *Clear and conspicuous standard—rates and payments in advertisements for credit secured by a dwelling*. For purposes of § 226.24(f), a clear and conspicuous disclosure means that the required information in §§ 226.24(f)(2)(i) and 226.24(f)(3)(i)(A) and (B) is disclosed with equal prominence and in close proximity to the advertised rates or payments triggering the required disclosures, and that the required information in § 226.24(f)(3)(i)(C) is disclosed with prominence and in close proximity to the advertised rates or payments triggering the required disclosures. If the required information in §§ 226.24(f)(2)(i) and 226.24(f)(3)(i)(A) and (B) is the same type size as the advertised rates or payments triggering the required disclosures, the disclosures are deemed to be equally prominent. The information in § 226.24(f)(3)(i)(C) must be disclosed with prominence, but need not be disclosed with equal prominence or be the same type size as the payments triggering the required disclosures. If the required information in §§ 226.24(f)(2)(i) and 226.24(f)(3)(i) is located immediately next to or directly above or below the advertised rates or payments triggering the required disclosures, without any intervening text or graphical displays, the disclosures are deemed to be in close proximity. Notwithstanding the above, for electronic advertisements that disclose rates or payments, compliance with the requirements of § 226.24(e) is deemed to satisfy the clear and conspicuous standard.

3. *Clear and conspicuous standard—Internet advertisements for credit secured by a dwelling*. For purposes of this section, a clear and conspicuous disclosure for visual text advertisements on the Internet for credit secured by a dwelling means that the required disclosures are not obscured by techniques such as graphical displays, shading, coloration, or other devices and comply with all other requirements for clear and conspicuous disclosures under § 226.24. *See also* comment 24(e)–4.

4. *Clear and conspicuous standard—televised advertisements for credit secured by a dwelling*. For purposes of this section, and except as otherwise provided by § 226.24(g) for alternative disclosures, a clear and conspicuous disclosure in the context of visual text advertisements on television for credit secured by a dwelling means that the required disclosures are not obscured by techniques such as graphical displays, shading, coloration, or other devices, are displayed in a manner that allows a consumer to read the information required to be disclosed, and comply with all other requirements for clear and conspicuous disclosures under § 226.24. For example, very fine print in a television advertisement would not meet the clear and conspicuous standard if consumers cannot see and read the information required to be disclosed.

5. *Clear and conspicuous standard—oral advertisements for credit secured by a dwelling*. For purposes of this section, and except as otherwise provided by § 226.24(g) for alternative disclosures, a clear and conspicuous disclosure in the context of an oral advertisement for credit secured by a dwelling, whether by radio, television, or other medium, means that the required disclosures are given at a speed and volume sufficient for a consumer to hear and comprehend them. For example, information stated very rapidly at a low volume in a radio or television advertisement would not meet the clear and conspicuous standard if consumers cannot hear and comprehend the information required to be disclosed.◄

24►(c)◄[(b)] Advertisement of rate of finance charge.

* * * * *

2. *Simple or periodic rates*. The advertisement may not simultaneously state any other rate, except that a simple annual rate or periodic rate applicable to an unpaid balance may appear along with (but not more conspicuously than) the annual percentage rate. ►An advertisement for credit secured by a dwelling may not state a periodic rate, other than a simple annual rate, that is applied to an unpaid balance.◄ For example►,◄[:]

[• I]►i◄n an advertisement for [real estate] ►credit secured by a dwelling◄, a simple ►annual◄ interest rate may be shown in the same type size as the annual percentage rate for the advertised credit►, subject to the requirements of section 226.24(f)◄. ►A simple annual rate or periodic rate that is applied to an unpaid balance is the rate at which interest is accruing; those terms do not include a rate lower than the rate at which interest is accruing, such as an effective rate, payment rate, or qualifying rate.◄

3. *Buydowns.* When a third party (such as a seller) or a creditor wishes to promote the availability of reduced interest rates (consumer or seller buydowns), the advertised annual percentage rate must be determined in accordance with [the rules in] the commentary to § 226.17(c) regarding the basis of transactional disclosures for buydowns. The seller or creditor may advertise the reduced simple interest rate, provided the advertisement shows the limited term to which the reduced rate applies and states the simple interest rate applicable to the balance of the term. The advertisement may also show the effect of the buydown agreement on the payment schedule for the buydown period►, but this will◄ [without] trigger[ing] the additional disclosures under § 226.24►(d)◄[(c)](2). [For example, the advertisement may state that ''with this buydown arrangement, your monthly payments for the first three years of the mortgage term will be only $350'' or ''this buydown arrangement will reduce your monthly payments for the first three years of the mortgage term by $150.'']

[4. *Effective rates.* In some transactions the consumer's payments may be based upon an interest rate lower than the rate at which interest is accruing. The lower rate may be referred to as the effective rate, payment rate, or qualifying rate. A creditor or seller may advertise such rates by stating the term of the reduced payment schedule, the interest rate upon which the reduced payments are calculated, the rate at which the interest is in fact accruing, and the annual percentage rate. The advertised annual percentage rate that must accompany this rate must take into account the interest that will accrue but will not be paid during this period. For example, an advertisement may state, ''An effective first-year interest rate of 10 percent. Interest being earned at 14 percent. Annual percentage rate 15 percent.'']

►4◄[5]. *Discounted variable-rate transactions.* The advertised annual percentage rate for discounted variable-rate transactions must be determined in accordance with comment 17(c)(1)–10 regarding the basis of transactional disclosures for such financing.

►i.◄ A creditor or seller may promote the availability of the initial rate reduction in such transactions by advertising the reduced [initial] ►simple annual◄ rate, provided the advertisement shows ►with equal prominence and in close proximity◄ the limited term to which the reduced rate applies ►and the annual percentage rate that will apply after the term of the initial rate reduction expires. *See* § 226.24(f)◄.

►ii.◄[•] Limits or caps on periodic rate or payment adjustments need not be stated. To illustrate using the second example in comment 17(c)(1)–10, the fact that the rate is presumed to be 11 percent in the second year and 12 percent for the remaining 28 years need not be included in the advertisement.

►iii.◄[•] The advertisement may also show the effect of the discount on the payment schedule for the discount period►, but this will◄ [without] trigger[ing] the additional disclosures under § 226.24(d). [For example, the advertisement may state that ''with this discount, your monthly payments for the first year of the mortgage term will be only $577'' or ''this discount will reduce your monthly payments for the first year of mortgage term by $223.'']

24►(d)◄[(c)] Advertisement of terms that require additional disclosures.

1. *General rule.* Under § 226.24►(d)◄[(c)](1), whenever certain triggering terms appear in credit advertisements, the additional credit terms enumerated in § 226.24►(d)◄[(c)](2) must also appear. These provisions apply even if the triggering term is not stated explicitly but may be readily determined from the advertisement. For example, an advertisement may state ''80 percent financing available,'' which is in fact indicating that a 20 percent downpayment is required.

Paragraph 24►(d)◄[(c)](1).

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3. *Payment amount.* The dollar amount of any payment includes statements such as:

- ''Payable in installments of $103''
- ''$25 weekly''
- ►• ''$500,000 loan for just $1,650 per month''◄
- ''$1,200 balance payable in 10 equal installments''

In the last example, the amount of each payment is readily determinable, even though not explicitly stated. But statements such as ''monthly payments to suit your needs'' or ''regular monthly payments'' are not covered.

* * * * *

Paragraph 24►(d)◄[(c)](2).

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2. *Disclosure of repayment terms.* [While t]►T◄he phrase ''terms of repayment'' generally has the same meaning as the ''payment schedule'' required to be disclosed under § 226.18(g)►.◄[,] [s]►S◄ection 226.24►(d)◄[(c)](2)(ii) provides [greater] flexibility to creditors in making this disclosure for advertising purposes. Repayment terms may be expressed in a variety of ways in addition to an exact repayment schedule; this is particularly true for advertisements that do not contemplate a single specific transaction. ►Repayment terms, however, must reflect the consumer's repayment obligations over the full term of the loan, including any balloon payment, *see* comment 24(d)(2)(iii), not just the repayment terms that will apply for a limited period of time.◄ For example:

►i.◄[•] A creditor may use a unit-cost approach in making the required disclosure, such as ''48 monthly payments of $27.83 per $1,000 borrowed.''

[• In an advertisement for credit secured by a dwelling, when any series of payments varies because of a graduated-payment feature or because of the inclusion of mortgage insurance premiums, a creditor may state the number and timing of payments, and the amounts of the largest and smallest of those payments, and the fact that other payments will vary between those amounts.]

►ii. In an advertisement for credit secured by a dwelling, when any series of payments varies because of the inclusion of mortgage insurance premiums, a creditor may state the number and timing of payments, the amounts of the largest and smallest of those payments, and the fact that other payments will vary between those amounts.

iii. In an advertisement for credit secured by a dwelling, when one series of monthly payments will apply for a limited period of time followed by a series of higher monthly payments for the remaining term of the loan, the advertisement must state the number and time period of each series of payments, and the amounts of each of those payments. For this purpose, the creditor must assume that the consumer makes the lower series of payments for the maximum allowable period of time.

3. *Balloon payment; disclosure of repayment terms.* In some transactions, a balloon payment will occur when the consumer only makes the minimum payments specified in an advertisement. A balloon payment results if paying the minimum payments does not fully amortize the outstanding balance by a specified date or time, usually the end of the term of the loan, and the consumer must repay the entire outstanding balance at such time. If a balloon payment will occur when the consumer only makes the minimum payments specified in an advertisement, the advertisement must state with equal prominence and in close proximity to the minimum payment statement the amount and timing of the balloon payment that will result if the consumer makes only the minimum payments for the maximum period of time that the consumer is permitted to make such payments.

4.◄[3.] *Annual percentage rate.* The advertised annual percentage rate may be expressed using the abbreviation APR. The advertisement must also state, if applicable, that the annual percentage rate is subject to increase after consummation.

►5.◄[4.] *Use of examples.* ►A creditor may use◄ [Footnote 49 authorizes the use of] illustrative credit transactions to make the necessary disclosures under § 226.24►(d)◄[(c)](2). That is, where a range of possible combinations of credit terms is offered, the advertisement may use examples of typical transactions, so long as each example contains all of the applicable terms required by § 226.24►(d)◄[(c)]. The examples must be labeled as such and must reflect representative credit terms [that are] made available by the creditor to present and prospective customers.

24►(e)◄[(d)] Catalogs or other multiple-page advertisements; electronic advertisements.

1. *Definition.* The multiple-page advertisements to which this section refers are advertisements consisting of a series of

sequentially numbered pages—for example, a supplement to a newspaper. A mailing consisting of several separate flyers or pieces of promotional material in a single envelope does not constitute a single multiple-page advertisement for purposes of § 226.24►(e)◄[(d)].

2. *General.* Section 226.24►(e)◄[(d)] permits creditors to put credit information together in one place in a catalog or other multiple-page advertisement or in an electronic advertisement (such as an advertisement appearing on an Internet Web site). The rule applies only if the advertisement contains one or more of the triggering terms from § 226.24►(d)◄[(c)](1). A list of different annual percentage rates applicable to different balances, for example, does not trigger further disclosures under § 226.24►(d)◄[(c)](2) and so is not covered by § 226.24►(e)◄[(d)].

* * * * *

4. *Electronic advertisement.* If an electronic advertisement (such as an advertisement appearing on an Internet Web site) contains the table or schedule permitted under § 226.24►(e)◄[(d)](1), any statement of terms set forth in § 226.24►(d)◄[(c)](1) appearing anywhere else in the advertisement must clearly direct the consumer to the location where the table or schedule begins. For example, a term triggering additional disclosures may be accompanied by a link that directly takes the consumer to the additional information.

►*24(f) Disclosure of rates and payments in advertisements for credit secured by a dwelling.*

1. *Equal prominence, close proximity.* Information required to be disclosed under §§ 226.24(f)(2)(i) and 226.24(f)(3)(i) that is in the same paragraph as the simple annual rate or payment amount (not in a footnote to that paragraph) is deemed to be closely proximate to the listing. Information required to be disclosed under §§ 226.24(f)(2)(i) and 226.24(f)(3)(i)(A) and (B) that is in the same type size as the simple annual rate or payment amount is deemed to be equally prominent.

2. *Clear and conspicuous standard.* For more information about the applicable clear and conspicuous standard, see comment 24(b)–2.

3. *Comparisons in advertisements.* When making any comparison in an advertisement between an actual or hypothetical consumer's current credit payments or rates and the payments or rates available under the advertised product, the advertisement must state all applicable payments or rates for the advertised product and the time periods for which those payments or rates will apply, as required by this section.

4. *Application to variable-rate transactions—disclosure of rates.* In advertisements for variable-rate transactions, if a simple annual rate that applies at consummation is not based on the index and margin that will be used to make subsequent rate adjustments over the term of the loan, the requirements of § 226.24(f)(2)(i) apply.

5. *Reasonably current index and margin.* For the purposes of this section, an index and margin is considered reasonably current if:

i. For direct mail advertisements, it was in effect within 60 days before mailing;

ii. For advertisements in electronic form, it was in effect within 30 days before the advertisement is sent to a consumer's e-mail address, or in the case of an advertisement made on an Internet Web site, when viewed by the public; or

iii. For printed advertisements made available to the general public, including ones contained in a catalog, magazine, or other generally available publication, it was in effect within 30 days before printing.

24(f)(3) Disclosure of payments.

1. *Amounts and time periods of payments.* Section 226.24(f)(3)(i) requires disclosure of the amounts and time periods of all payments that will apply over the term of the loan. This section may require disclosure of several payment amounts, including any balloon payment. For example, if an advertisement for credit secured by a dwelling offers $300,000 of credit with a 30-year loan term for a payment of $600 per month for the first six months, increasing to $1,500 per month after month six, followed by a balloon payment of $30,000 at the end of the loan term, the advertisement must disclose the amount and time periods of each of the two monthly payment streams, as well as the amount and timing of the balloon payment, with equal prominence and in close proximity to each other.

2. *Application to variable-rate transactions—disclosure of payments.* In advertisements for variable-rate transactions, if the payment that applies at consummation is not based on the index and margin that will be used to make subsequent payment adjustments over the term of the loan, the requirements of § 226.24(f)(3)(i) apply.

24(g) Alternative disclosures—television or radio advertisements.

1. *Toll-free number, local or collect calls.* In complying with the disclosure requirements of § 226.24(g), an advertisement must provide a toll-free telephone number. Alternatively, an advertisement may provide any telephone number that allows a consumer to reverse the phone charges when calling for information.

2. *Multi-purpose number.* When an advertised toll-free telephone number provides a recording, disclosures should be provided early in the sequence to ensure that the consumer receives the required disclosures. For example, in providing several options—such as providing directions to the advertiser's place of business—the option allowing the consumer to request disclosures should be provided early in the telephone message to ensure that the option to request disclosures is not obscured by other information.

3. *Statement accompanying toll free number.* Language must accompany a telephone number indicating that disclosures are available by calling the toll-free number, such as ''call 1–800–000–0000 for details about credit costs and terms.''

24(h) Statements of tax deductibility.

1. *When disclosures not required.* An advertisement for a home-secured loan where the loan's terms do not allow for extensions of credit greater than the fair market value of the consumer's dwelling need not give the disclosures regarding which portions of the interest are tax deductible.

24(i) Prohibited acts or practices in advertisements for credit secured by a dwelling.

1. *Misleading comparisons in advertisements—savings claims.* A misleading comparison includes a claim about the amount a consumer may save under the advertised product. For example, a statement such as ''save $300 per month on a $300,000 loan'' constitutes an implied comparison between the advertised product's payment and a consumer's current payment.

2. *Misrepresentations about government endorsement.* A statement that the federal Community Reinvestment Act entitles the consumer to refinance his or her mortgage at the low rate offered in the advertisement is prohibited because it conveys a misleading impression that the advertised product is endorsed or sponsored by the federal government.

3. *Misleading claims of debt elimination.* The prohibition against misleading claims of debt elimination or waiver or forgiveness does not apply to claims that the advertised product may reduce debt payments, consolidate debts, or shorten the term of the debt. Examples of misleading claims of debt elimination or waiver or forgiveness of loan terms with, or obligations to, another creditor of debt include: ''Wipe-Out Personal Debts!'', ''New DEBT-FREE Payment'', ''Set yourself free; get out of debt today'', ''Refinance today and wipe your debt clean!'', ''Get yourself out of debt * * * Forever!'', and ''Pre-payment Penalty Waiver.''◄

Subpart E—Special Rules for Certain Home Mortgage Transactions

Section 226.32—Requirements for Certain Closed-End Home Mortgages

32(a) Coverage.

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►*Paragraph 32(a)(2)*

1. *Exemption limited.* Section 226.32(a)(2) lists certain transactions as being exempt from the provisions of § 226.32. Nevertheless, those transactions may be subject to the provisions of § 226.35, including any provisions of § 226.32 to which § 226.35 refers. *See* 12 CFR 226.35(a).◄

* * * * *

32(d) Limitations.

►1. *Additional prohibitions applicable under other sections.* Section 226.34 sets forth certain prohibitions in connection with mortgage credit subject to § 226.32, in addition to the limitations in § 226.32(d). Further, § 226.35(b) prohibits certain practices in connection with transactions that meet the coverage test in § 226.35(a). Because the coverage test in § 226.35(a) is generally broader than the coverage test in § 226.32(a), most § 226.32 mortgage loans are also subject to the prohibitions set forth in § 226.35(b), in addition to the limitations in § 226.32(d).◄

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32(d)(7) Prepayment penalty exception.

►1. *Other application of section.* The conditions in § 226.32(d)(7) apply to prepayment penalties on mortgage transactions described in § 226.32(a). In

addition, these conditions apply to mortgage transactions covered by § 226.35(a).◄

Paragraph 32(d)(7)(iii).

[1. *Calculating debt-to-income ratio.* ''Debt'' does not include amounts paid by the borrower in cash at closing or amounts from the loan proceeds that directly repay an existing debt. Creditors may consider combined debt-to-income ratios for transactions involving joint applicants.

2. *Verification.* Verification of employment satisfies the requirement for payment records for employment income.]

►1. *Classifying debt and income.* To determine whether to classify particular funds or obligations as ''debt'' or ''income'' under the prepayment penalty exception in § 226.32(d)(7)(iii), creditors may look to widely accepted governmental and non-governmental underwriting standards, including, for example, those set forth in the Federal Housing Administration's handbook on Mortgage Credit Analysis for Mortgage Insurance on One-to Four-Unit Mortgage Loans.

2. *Debt described.* i. For purposes of § 226.32(d)(7)(iii), ''debt'' includes, but is not limited to, the consumer's liabilities and obligations for:

A. Housing expenses;

B. Loans such as installment and real estate loans;

C. Open-end credit plans; and

D. Alimony, child support, and separate maintenance.

ii. ''Debt'' does not include amounts paid by a borrower in cash at closing or amounts from the loan proceeds that directly repay an existing debt.

3. *Income described.* For purposes of § 226.32(d)(7)(iii), ''income'' includes, but is not limited to, funds a consumer receives:

i. From employment (whether full-time, part-time, seasonal, military, or self-employment), including without limitation salary, wages, base pay, overtime pay, bonus pay, tips, and commissions;

ii. As interest or dividends;

iii. As retirement benefits or public assistance; and

iv. As alimony, child support, or separate maintenance payments, to the extent permitted under Regulation B, 12 CFR 202.5(d)(2), 202.6(b)(5).

4. *Verification.* Creditors shall verify income in the manner described in § 226.35(b)(2)(i) and the related comments. Creditors may verify debt with a credit report.

Paragraph 32(d)(7)(iv).

1. *Changes in payment amounts.* Section 226.32(d)(7)(iv) permits a prepayment penalty only if the period during which the penalty may be imposed ends at least sixty days prior to the first date, if any, on which the principal or interest payment amount may increase under the terms of the loan. This permits a consumer to refinance or otherwise pay off all or part of the loan, without a penalty, sixty days before there is an increase in the payment of interest or principal. For example, the principal or interest payment amount may increase because—

i. The loan's interest rate increases;

ii. Scheduled payments of principal or interest increase independently of interest rate changes, for example with a graduated or step-rate transaction; or

iii. Negative amortization occurs and, under the loan terms, triggers an increase in principal or interest payment amounts.

2. *Payment increases excluded from § 226.32(d)(7)(iv).* Payment increases due to the following circumstances are not considered payment increases for purposes of § 226.32(d)(7)(iv):

i. Actual unanticipated late payment, the borrower's delinquency, or default; and

ii. Increased payments made solely at the consumer's option, such as when a consumer chooses to make a payment of interest and principal on a loan that only requires the consumer to pay interest.◄

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Section 226.34—Prohibited Acts or Practices in Connection with Credit [*Secured by a Consumer's Dwelling; Open-end Credit*] ►*Subject to § 226.32*◄

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

* * * * *

34(a)(4) Repayment ability.

►1. *Application of repayment ability rule to § 226.35(a) higher-cost mortgage loans.* The § 226.34(a)(4) prohibition against a pattern or practice of making loans without regard to consumers' repayment ability applies to creditors making mortgage loans described in § 226.32(a). In addition, the § 226.34(a)(4) prohibition applies to creditors making higher-cost mortgage transactions, including residential mortgage transactions, described in § 226.35(a). *See* 12 CFR 226.35(b)(1).

2. *Determination as of consummation.* Section 226.34(a)(4) prohibits a creditor from engaging in a pattern or practice of extending credit subject to § 226.32 to consumers based on the value of consumers' collateral without regard to consumers' repayment ability as of consummation. This prohibition is based on the facts and circumstances that existed as of consummation. Events after consummation may be relevant to determining whether a creditor has violated § 226.34(a)(4), but events after consummation do not, by themselves, establish a violation. For example, a violation is not established if borrowers default after consummation because of serious illness or job loss.◄

[1.]►3.◄ *Income*►*, assets, and employment*◄. Any ►current or reasonably expected assets or current or reasonably◄ expected income [can] ►may◄ be considered by the creditor, except ►the collateral itself◄ [equity income that would be realized from collateral]. For example, a creditor may use information about ►current or expected◄ income other than regular salary or wages, such as income described in paragraph 226.32(d)(7)(iii)–(3) [such as gifts, expected retirement payments, or income from self-employment, such as housecleaning or childcare]. ►Employment should also be considered. In some circumstances, it may be appropriate or necessary to take into account expected changes in employment. For example, depending on all of the facts and circumstances, it may be reasonable to assume that students obtaining professional degrees or certificates will obtain employment upon receiving the degree or certificate. In other circumstances, a creditor may have information indicating that an employed person will become unemployed. A creditor may also take into account assets such as savings accounts or investments that can be used by the consumer.◄

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

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

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

►*Paragraph 34(a)(4)(i).*

1. *Presumptions.* Section 226.34(a)(4)(i) sets forth particular patterns or practices that would create a presumption that a creditor has violated § 226.34(a)(4). These presumptions may be rebutted with sufficient evidence that a creditor did not engage in a pattern or practice of disregarding repayment ability. These presumptions are also not exhaustive. That is, a creditor may violate § 226.34(a)(4) by patterns or practices other than those specified in § 226.34(a)(4)(i).

Paragraph 34(a)(4)(i)(A).

1. *Failure to verify income and assets relied on.* A creditor is presumed to have violated the prohibition on lending without regard to repayment ability if the creditor has engaged in a pattern or practice of failing to verify and document repayment ability. A pattern or practice of failing to document and verify income and assets relied on to make the credit decision as required by § 226.35(b)(2)(i) would trigger this presumption.

2. *Failure to verify obligations.* A pattern or practice of failing to verify obligations would also trigger this presumption. In general, a credit report may be used to verify obligations. Where two different creditors are extending loans simultaneously, one a first-lien loan and the other a subordinate-lien loan, each creditor is expected to verify the obligation the consumer is undertaking with the other creditor. A pattern or practice of

failing to do so would create a presumption of a violation.

Paragraph 34(a)(4)(i)(B).

1. *Variable rate loans.* For some variable rate loans, the initial interest rate is not based on the index and margin or formula used for later adjustments. In such cases, a pattern or practice of failing to consider the consumer's ability to make loan payments based on the index and margin or formula used for later adjustments, or the initial interest rate, if greater than the sum of the index and margin at consummation, would lead to a presumption that the creditor has violated § 226.34(a)(4)(i)(B). For examples of these and other variable rate loans, see comment 17(c)(1)–10.

Paragraph 34(a)(4)(i)(D).

1. *Failure to consider debt-to-income ratio.* A creditor is presumed to have violated the prohibition against lending without regard to repayment ability if the creditor has engaged in a pattern or practice of failing to consider the ratio of consumers' total debt obligations to consumers' income. For this purpose, a creditor may rely on the commentary to § 226.32(d)(7)(iii) to determine the components of debt and income. Unlike § 226.32(d)(7)(iii), however, § 226.34(a)(4)(i)(D) does not identify a specific debt to income ratio. Although a pattern of unusually high ratios may be evidence that a creditor has violated § 226.34(a)(4), compliance is determined on the basis of all the facts and circumstances relevant to repayment ability.

Paragraph 34(a)(4)(i)(E).

1. *Failure to consider residual income.* A creditor is presumed to have violated the prohibition against lending without regard to repayment ability if the creditor has engaged in a pattern or practice of failing to consider consumers' residual income. Paragraph (a)(4)(i)(E) requires a creditor to consider whether consumers will have sufficient income, after paying the new obligation and existing obligations, to cover ordinary living expenses.◄

* * * * *

►*Section 226.35—Acts or Practices in Connection With Higher-priced Mortgage Loans*

35(a) Coverage.

1. *In general.* To determine whether a loan is a higher-priced mortgage loan for purposes of the limitations set forth in this section, a creditor must use the rules for determining the applicable Treasury security set forth in § 226.35(a). (Note: these rules are different from the rules in § 226.32(a).)

2. *Treasury securities.* To determine the yield on comparable Treasury securities, creditors may use the yield on actively traded issues adjusted to constant maturities published in the Board's ''Selected Interest Rates'' (statistical release H–15). Further guidance can be found in comments 35(a)(2)–1 and 35(a)(3)–1.

Paragraph 35(a)(2).

1. *In general.* Section 226.35(a)(2) sets forth the rules for identifying comparable Treasury securities for variable rate transactions. A variable rate transaction is one in which the annual percentage rate may increase after consummation. (See comment 226.18(f)–1. See also comments 226.17(c)(1)–8 and –10 for guidance on calculating the annual percentage rate for a variable rate transaction.) The rules in § 226.35(a)(2) apply to all variable rate transactions, regardless of whether the initial rate is a discounted or premium rate, or is determined by the index and margin used to make later adjustments. If the initial interest rate is fixed for more than one year, § 226.35(a)(2) requires the creditor to use the yield on the Treasury security matching the duration of the initial interest rate. For example—

i. In the case of a variable rate loan with an initial interest rate fixed for the first five years based on the value of the index at consummation plus the margin, and adjusting thereafter, a creditor would use the yield on the constant maturity of five years, such as published in the statistical release H–15;

ii. In the case of a variable rate loan with an initial interest rate that is a discounted or premium rate for the first five years and adjusts thereafter based on an index and margin, a creditor would use the yield on the constant maturity of five years published in the statistical release H–15;

iii. In the case of a variable rate loan, if the initial interest rate is fixed for the first four years (either at the value of the index at consummation plus margin or at a discounted or premium rate), and the statistical release H–15 does not report a constant maturity of four years but reports a maturity of three years and a maturity of five years, the creditor may use the yield from either maturity; and

iv. In the case of a variable rate loan, if the interest rate will adjust within the first year, the creditor would use the yield on the constant maturity of one year regardless of the length of any initial rate. For example, if the initial interest rate is fixed for one month and adjusts monthly thereafter, the creditor would use the yield on the constant maturity of one year.

Paragraph 35(a)(3).

1. *In general.* Section 226.35(a)(3) sets forth the rules for identifying yields on comparable Treasury securities for transactions other than variable rate transactions. Under these rules, for a transaction with a term of 30 years, the creditor would compare the APR to the yield on the constant Treasury maturity of ten years on statistical release H–15. For a transaction with a term of 15 years, the creditor would use the yield on the constant Treasury maturity of seven years. For a transaction with a term of five years, the creditor would use the yield on the constant Treasury maturity of five years.

2. *Balloon loans.* A creditor must look to the term of the loan regardless of the amortization period of the loan. For example, if a creditor extends a five-year ''balloon'' loan with payments based on a 30-year amortization, the creditor should use the yield on the constant Treasury maturity of five years.

Paragraph 35(a)(4).

1. *Application date.* An application is deemed received when it reaches the creditor in any of the ways applications are normally transmitted. See comment 226.19(a)(1)–3. An application transmitted through an intermediary agent or broker is received when it reaches the creditor, rather than when it reaches the agent or broker. See comment 19(b)–3 to determine whether a transaction involves an intermediary agent or broker.

2. *When 15th of the month is not a business day.* If the most recent 15th of the month is not a business day, the creditor must use the yield on the constant Treasury maturity as of the business day immediately preceding the 15th.

Paragraph 35(b)(2).

1. *Income and assets relied on.* A creditor must comply with § 226.35(b)(2)(i) with respect to the income and assets relied on in evaluating the creditworthiness of consumers. For example, if a consumer earns both a salary and an annual bonus, but the creditor only relies on the applicant's salary to evaluate creditworthiness, the creditor need only comply with § 226.35(b)(2)(i) with respect to the salary.

2. *Income and assets—co-applicant.* If two persons jointly apply for credit and both list income or assets on the application, the creditor must comply with § 226.35(b)(2) with respect to both applicants unless the creditor only relies on the income or assets of one of the applicants.

3. *Income and assets—guarantors.* A creditor does not need to comply with § 226.35(b)(2) with respect to the income or assets of a person who is not primarily liable on the obligation, such as a guarantor.

4. *Expected income.* A creditor may rely on a consumer's expected income, except equity income that would be realized from collateral, so long as the creditor verifies the basis for that expectation using documents listed under § 226.35(b)(2)(i), including third-party documents that provide reasonably reliable evidence of the borrower's expected income. For example, if, based on a consumer's statement, the creditor relies on an expectation that a consumer will receive an annual bonus, the creditor may verify the basis for that expectation with documents that show the consumer's past annual bonuses. Similarly, if the creditor relies on a consumer's expected salary following the consumer's receipt of an educational degree, the creditor may verify that expectation with a written statement from an employer indicating that the consumer will be employed upon graduation and the salary.

Paragraph 35(b)(2)(i).

1. *Internal Revenue Service (IRS) Form W–2.* A creditor may verify a consumer's income using an IRS Form W–2 (or any subsequent revisions or similar IRS Forms used for reporting wages and tax withholding). The lender may also use an electronic retrieval service for obtaining the consumer's W–2 information.

2. *Tax returns.* A creditor may verify a consumer's income or assets using the consumer's tax return. A creditor may also use IRS Form 4506 ''Request for Copy of Tax Return,'' Form 4506–T ''Request for Transcript of Tax Return,'' or Form 8821 ''Tax Information Authorization'' (or any subsequent revisions or similar IRS Forms appropriate for obtaining tax return information directly from the IRS) to verify the consumer's income or assets. The lender

may also use an electronic retrieval service for obtaining tax return information.

3. *Other third-party documents that provide reasonably reliable evidence of consumer's income or assets.* Creditors may verify income and assets using other documents produced by third parties that provide reasonably reliable evidence of the consumer's income or assets. For example, creditors may verify the consumer's income using receipts from a check-cashing service, or by obtaining a written statement from the consumer's employer that states the consumer's income.

4. *Duplicative collection of documentation.* A creditor that has made a loan to a consumer and is refinancing or extending new credit to the same consumer need not collect from the consumer a document the creditor previously examined if that document presumably will not have changed since it was initially collected. For example, if the creditor has collected the consumer's 2006 tax return to make a loan in May 2007, the creditor may rely on the 2006 tax return if the creditor makes another loan to the same consumer in August 2007. Using the same example, if the creditor has collected the consumer's bank statement for May 2007 in making the first loan, the creditor may rely on that bank statement for that month in making the subsequent loan in August.

Paragraph 35(b)(2)(ii).

1. *No violation if income or assets relied on were not materially greater than verifiable amounts.* A creditor must verify amounts of income or assets relied upon in extending credit for a higher-priced mortgage loan. However, the creditor does not violate § 226.35(b)(2) if it demonstrates that the income or assets relied upon were not materially greater than the amounts that the creditor would have been able to verify pursuant to § 226.35(b)(2)(i) at consummation. For example, if a creditor approves an extension of credit relying on a consumer's annual income of $40,000 but fails to obtain documentation of that amount before extending the credit, the creditor will not have violated this section if the creditor later obtains evidence that would satisfy § 226.35(b)(2)(i), such as tax return information, showing that the consumer had an annual income of at least $40,000 at the time the loan was consummated.◄

►*Section 226.36—Prohibited Acts or Practices in Connection with Credit Secured by a Consumer's Principal Dwelling*

36(a) Creditor payments to mortgage brokers.

Paragraph 36(a)(1).

1. *Timing of agreement.* The agreement under § 226.36(a)(1) must be entered into by the consumer and mortgage broker before the consumer pays a fee to any person or submits a written application for the credit transaction to the broker, whichever occurs first. The agreement must be entered into before the consumer's payment of any fee, regardless of whether the fee is received or retained by the broker. The agreement also must be entered into before the consumer submits a written application for the credit transaction to the broker.

2. *Written agreement.* The agreement under § 226.36(a)(1) must be in writing and must be a legally enforceable contract under applicable law. As evidence of compliance with this section, a creditor may rely on a written agreement that meets the criteria set forth in § 226.36(a)(1)(i)–(iii) and is signed and contemporaneously dated by the consumer and the broker, together with documentation (such as the HUD–1 Settlement Statement prepared in accordance with RESPA) that the creditor's payment to a broker does not exceed the amount provided for in the written agreement, taking into account any portion of that amount received by the broker directly from the consumer or out of loan proceeds.

3. *Clear and conspicuous.* The three statements required by § 226.36(a)(1)(i)–(iii) are clear and conspicuous if they are noticeable, grouped together, and prominently placed on the first page of the written agreement. They are noticeable if they are at least as large as the largest type size used in the rest of the agreement's text. This standard also requires that the statements be reasonably understandable. The following example would be considered reasonably understandable: ''The total fee I/we will receive for your loan is $ _____. You will pay this entire amount. The lender will increase your interest rate if the lender pays any part of this amount. A lender payment to a mortgage broker can influence which loan products and terms the broker offers you, which may not be in your best interest or may be less favorable than you otherwise could obtain.''

Paragraph 36(a)(1)(i).

1. *Total amount of broker's compensation.* The agreement must set forth the total compensation the mortgage broker will receive and retain as a dollar amount. The broker's total compensation stated in the agreement is limited to amounts that the broker both receives and retains. It does not include amounts received by the broker and paid to third parties for other services obtained in connection with the transaction, such as a fee for an appraisal or inspection, provided such amounts actually are paid to and retained by third parties.

Paragraph 36(a)(2).

1. *Effect of section.* Section 226.36(a)(2) provides two exceptions to the general rule in § 226.36(a)(1). Creditor payments to mortgage brokers that qualify for either exception are not subject to the prohibition on creditor payments to mortgage brokers. Accordingly, in such cases, the agreement prescribed by § 226.36(a)(1) is not required.

Paragraph 36(a)(2)(i).

1. *State statute or regulation.* A state statute or regulation may impose a specific duty on mortgage brokers, under which a broker may not offer loan products or terms that are less favorable than the consumer otherwise could obtain through the same broker, assuming the same loan terms and conditions. For example, such a law may impose a duty on brokers to act solely in the consumer's best interests. Where brokers are subject by law to such a duty, and the applicable statute or regulation requires brokers to provide consumers with a written agreement that describes the broker's role and relationship to the consumer, § 226.36(a)(1) does not apply.

Paragraph 36(a)(2)(ii).

1. *Compensation not determined by reference to interest rate.* Where a creditor can demonstrate that the compensation it pays to a mortgage broker is not based on the interest rate for the transaction, § 226.36(a)(1) does not apply. This exception would be available, for example, if a creditor can show that it pays brokers the same flat fee for all transactions, regardless of the interest rate. Under this exception, unlike the general rule of § 226.36(a)(1), no part of the broker's compensation may be based on the interest rate, even if the consumer is aware of the relationship and agrees to it. Creditor payments to brokers may vary, however, based on factors other than the interest rate (such as loan principal amount) without losing this exception.

36(b) Misrepresentation of value of consumer's principal dwelling.

36(b)(2) When extension of credit prohibited.

1. *Reasonable diligence.* A creditor will be deemed to have acted with reasonable diligence under § 226.36(b)(2) if the creditor extends credit based on an appraisal other than the one subject to the restriction in § 226.36(b)(2).

36(c) Mortgage broker defined.

1. *Meaning of mortgage broker.* Section 226.36(c) provides that a mortgage broker is any person who for compensation or other monetary gain arranges, negotiates, or otherwise obtains an extension of consumer credit, but is not an employee of a creditor. In addition, this definition expressly includes any person that satisfies this definition but makes use of ''table funding.'' Table funding occurs when a transaction is consummated with the debt obligation initially payable by its terms to one person, but another person provides the funds for the transaction at consummation and receives an immediate assignment of the note, loan contract, or other evidence of the debt obligation. Although § 226.2(a)(17)(1)(B) provides that a person to whom a debt obligation is initially payable on its face generally is a creditor, § 226.36(c) provides that, solely for the purposes of § 226.36, such a person is considered a mortgage broker. In addition, although consumers themselves often arrange, negotiate, or otherwise obtain extensions of consumer credit on their own behalf, they do not do so for compensation or other monetary gain and, therefore, are not mortgage brokers under this section.

36(d) Servicing practices.

Paragraph 36(d)(1)(i).

1. *Crediting of payments.* Under § 226.36(d)(1)(i), a mortgage servicer must credit a payment to a consumer's loan account as of the date of receipt. This does not require that a mortgage servicer post the payment to the consumer's loan account on a particular date; the servicer is only required to credit the payment *as of* the date of receipt. Accordingly, a servicer that receives a payment on or before its due date and does not enter the payment on its books or in its system until after the payment's due date does not violate this requirement as long as the entry does not result in the imposition of a late charge, additional interest, or similar penalty to the consumer, or in the reporting

of negative information to a consumer reporting agency.

2. *Date of receipt*. The ''date of receipt'' is the date that the payment instrument or other means of payment reaches the mortgage servicer. For example, payment by check is received when the mortgage servicer receives it, not when the funds are collected. If the consumer elects to have payment made by a third-party payor such as a financial institution, through a preauthorized payment or telephone bill-payment arrangement, payment is received when the mortgage servicer receives the third-party payor's check or other transfer medium, such as an electronic fund transfer.

Paragraph 36(d)(1)(ii).

1. *Pyramiding of late fees*. The prohibition on pyramiding of late fees in this subsection should be construed consistently with the ''credit practices rule'' of Regulation AA, 12 CFR 227.15.

Paragraph 36(d)(1)(iii).

1. *Fees and charges imposed by the servicer*. The schedule of fees and charges must include any third-party fees or charges assessed on the consumer by the servicer.

2. *Provision of schedule to consumer*. The servicer may provide the schedule to the consumer in writing or it may direct the consumer to a specific website address where the schedule is located. Any such website address reference must be specific enough to inform the consumer where the schedule is located, rather than solely referring to the servicer's home page.

3. *Dollar amount of fees and charges*. The dollar amount of a fee or charge may be expressed as a flat fee or, if a flat fee is not feasible, an hourly rate or percentage.

Paragraph 36(d)(1)(iv).

1. *Reasonable time*. The payoff statement must be provided to the consumer, or person acting on behalf of the consumer, within a reasonable time after the request. For example, it would be reasonable under normal market conditions to provide the statement within three business days of a consumer's request. This timeframe might be extended, for example, when the market is experiencing an unusually high volume of refinancing requests.

2. *Person acting on behalf of the consumer*. For purposes of § 226.36(d)(1)(iv), a person acting on behalf of the consumer may include the consumer's representative, such as an attorney representing the individual in pre-foreclosure or bankruptcy proceedings, a non-profit consumer counseling or similar organization, or a lender with which the consumer is refinancing and which requires the payoff statement to complete the refinancing.

Paragraph 36(d)(2).

1. *Payment requirements*. The servicer may specify reasonable requirements for making payments in writing, such as requiring that payments be accompanied by the account number; setting a cut-off hour for payment to be received, or setting different hours for payment by mail and payments made in person; specifying that only checks or money orders should be sent by mail; specifying that payment is to be made in U.S. dollars; or specifying one particular address for receiving payments, such as a post office box. The servicer may be prohibited, however, from specifying payment by preauthorized electronic fund transfer. (*See* section 913 of the Electronic Fund Transfer Act.)

2. *Implied guidelines for payments*. In the absence of specified requirements for making payments, payments may be made at any location where the servicer conducts business; any time during the servicer's normal business hours; and by cash, money order, draft, or other similar instrument in properly negotiable form, or by electronic fund transfer if the servicer and consumer have so agreed.►

By order of the Board of Governors of the Federal Reserve System, December 20, 2007.

Jennifer J. Johnson,

Secretary of the Board.

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