B.2 July 30, 2008 Amendments—Effective in 2009 or Later

Editor's Note: For the amendments to the Commentary, see Appx. C.2, infra.

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: Final rule; official staff commentary.

SUMMARY: The Board is publishing final rules amending 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 final rule applies four protections to a newly-defined category of higher-priced mortgage loans secured by a consumer's principal dwelling, including a prohibition on lending based on the collateral without regard to consumers' ability to repay their obligations from income, or from other sources besides the collateral. The revisions apply two new protections to mortgage loans secured by a consumer's principal dwelling regardless of loan price, including a prohibition on abusive servicing practices. The Board is also finalizing rules requiring that advertisements provide accurate and balanced information, in a clear and conspicuous manner, about rates, monthly payments, and other loan features. The advertising rules ban several deceptive or misleading advertising practices, including representations that a rate or payment is ''fixed'' when it can change. Finally, the revisions require creditors to provide consumers with transaction-specific mortgage loan disclosures within three business days after application and before they pay any fee except a reasonable fee for reviewing credit history.

DATES: This final rule is effective on October 1, 2009, except for § 226.35(b)(3)) which is effective on April 1, 2010. See part XIII, below, regarding mandatory compliance with § 226.35(b)(3) on mortgages secured by manufactured housing.

FOR FURTHER INFORMATION CONTACT: Kathleen C. Ryan or Dan S. Sokolov, Counsels; Paul Mondor, Senior Attorney; Jamie Z. Goodson, Brent Lattin, Jelena McWilliams, Dana E. Miller, or Nikita M. Pastor, 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.

SUPPLEMENTARY INFORMATION:

I. Summary of Final Rules

On January 9, 2008, the Board published proposed rules that would amend Regulation Z, which implements the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA). 73 FR 1672. The Board is publishing final amendments to Regulation Z to establish new regulatory protections for consumers in the residential mortgage market. 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 mortgage loans.

A. Rules To Prevent Unfairness, Deception, and Abuse

The Board is publishing 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 are 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 apply only to higher-priced mortgage loans, while others apply to all mortgage loans secured by a consumer's principal dwelling.

Protections Covering Higher-Priced Mortgage Loans

The Board is finalizing four protections for consumers receiving higher-priced mortgage loans. These loans are defined as consumer-purpose, closed-end loans secured by a consumer's principal dwelling and having an annual percentage rate (APR) that exceeds the average prime offer rates for a comparable transaction published by the Board by at least 1.5 percentage points for first-lien loans, or 3.5 percentage points for subordinate-lien loans. For higher-priced mortgage loans, the final rules:

○ Prohibit creditors from extending credit without regard to a consumer's ability to repay from sources other than the collateral itself;

○ Require creditors to verify income and assets they rely upon to determine repayment ability;

○ Prohibit prepayment penalties except under certain conditions; and

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

In addition, the final rules 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 open-end 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's rules:

○ 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, or failing to provide loan payoff statements upon request within a reasonable time.

The Board is withdrawing its proposal to require servicers to deliver a fee schedule to consumers upon request; and its proposal to prohibit creditors from paying a mortgage broker more than the consumer had agreed in advance that the broker would receive. The reasons for the withdrawal of these two proposals are discussed in parts X.A and X.C below.

Prospective Application of Final Rule

The final rule is effective on October 1, 2009, or later for the requirement to establish an escrow account for taxes and insurance for higher-priced mortgage loans. Compliance with the rules is not required before the effective dates. Accordingly, nothing in this rule should be construed or interpreted to be a determination that acts or practices restricted or prohibited under this rule are, or are not, unfair or deceptive before the effective date of this rule.

Unfair acts or practices can be addressed through case-by-case enforcement actions against specific institutions, through regulations applying to all institutions, or both. A regulation is prospective and applies to the market as a whole, drawing bright lines that distinguish broad categories of conduct. By contrast, an enforcement action concerns a specific institution's conduct and is based on all of the facts and circumstances surrounding that conduct.[1]

Because broad regulations, such as the rules adopted here, can require large numbers of institutions to make major adjustments to their practices, there could be more harm to consumers than benefit if the rules were effective immediately. If institutions were not provided a reasonable time to make changes to their operations and systems to comply with this rule, they would either incur excessively large expenses, which would be passed on to consumers, or cease engaging in the regulated activity altogether, to the detriment of consumers. And because the Board finds an act or practice unfair only when the harm outweighs the benefits to consumers or to competition, the implementation period preceding the effective date set forth in the final rule is integral to the Board's decision to restrict or prohibit certain acts or practices.

For these reasons, acts or practices occurring before the effective dates of these rules will be judged on the totality of the circumstances under other applicable laws or regulations. Similarly, acts or practices occurring after the rule's effective dates that are not governed by these rules will continue to be judged on the totality of the circumstances under other applicable laws or regulations.

B. Revisions To Improve Mortgage Advertising

Another goal of the final rules is to ensure that mortgage loan advertisements provide accurate and balanced information and do not contain misleading or deceptive representations. Thus the Board's rules 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. These rules are adopted under the Board's authorities to: adopt regulations to ensure consumers are informed about and can shop for credit; require that information, including the information required for advertisements for closed-end credit, be disclosed in a clear and conspicuous manner; and regulate advertisements of open-end home-equity plans secured by the consumer's principal dwelling. *See* TILA Section 105(a), 15 U.S.C. 1604(a); TILA Section 122, 15 U.S.C. 1632; TILA Section 144, 15 U.S.C. 1664; TILA Section 147, 15 U.S.C. 1665b.

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

○ Advertisements that state ''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;

○ Advertisements that compare an actual or hypothetical rate or payment obligation to 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;

○ Advertisements that make 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 is a ''counselor'' for 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.

[1] *See* Board and FDIC, CA 04–2, *Unfair Acts or Practices by State-Chartered Banks* (March 11, 2004), available at *http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20040311/attachment.pdf.*

C. Requirement To Give Consumers Disclosures Early

A third goal of these rules is to provide consumers transaction-specific disclosures early enough to use while shopping for a mortgage loan. The final rule requires 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 business days after application, and before the consumer pays any fee except a reasonable fee for the 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 began 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.[2] 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 2005—though about 68 percent now—and expanded consumers' access to the equity in their homes.

Recently, however, some of these benefits have 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 18 percent in May 2008, more than triple the mid-2005 level.[3] Adjustable-rate subprime mortgages have performed the worst, reaching a serious delinquency rate of 27 percent in May 2008, five times 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.[4] 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 8 percent (as of April 2008) from less than 2 percent only a year earlier. In contrast, 1.5 percent of loans in the prime-mortgage sector were seriously delinquent as of April 2008.

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 over 550,000 foreclosures in the first quarter of 2008, about half of them on subprime 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.[5]

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, particularly in the subprime sector. The loosening of underwriting standards is discussed in more detail in part II.B. The next section discusses underlying market imperfections that facilitated this loosening and made it difficult for consumers to avoid injury.

B. 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 their loans to be securitized.[6] The fragmentation of the originator market can further exacerbate the problem by making it more difficult for investors to monitor originators and for regulators to protect consumers.

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 reading a newspaper, telephoning brokers or lenders, or searching the Internet can easily obtain current prime interest rate quotes for free. In contrast, subprime rates, which can vary significantly based on the individual borrower's risk profile, are not broadly advertised and are usually obtainable only after application and paying a fee. Subprime rate quotes may not even be reliable if the originator engages in a ''bait and switch'' strategy. Price opacity is exacerbated because the subprime consumer often does not know her own credit score. Even if she knows her score, the prevailing interest rate for someone with that score and other credit risk characteristics is not generally publicly available.

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.[7] As discussed

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

[3] Delinquency rates calculated from data from First American LoanPerformance.

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

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

[6] Benjamin J. Keys, Tanmoy K. Mukherjee, Amit Seru and Vikram Vig, *Did Securitization Lead to Lax Screening? Evidence from Suprime Loans* at 22, available at: *http://ssrn.com/abstract=1093137*.

[7] U.S. Dep't of Housing & Urban Development and 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

earlier, subprime originations have much more often been ARMs than fixed rate mortgages. ARMs 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. Because the annual percentage rate (APR) does not reflect the price of the penalty, the consumer must both calculate the size of the penalty from a formula and assess the likelihood of moving or refinancing 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.[8] 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. 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—may reasonably decide not to shop further among originators or among loan options once an originator has told them they will receive a loan, because further shopping can be very costly. Shopping may require additional applications and application fees, and may delay the consumer's receipt of funds. This delay creates a potentially significant cost for the many subprime borrowers seeking to refinance their obligations to lower their debt payments at least temporarily, to extract equity in the form of cash, or both.[9] In recent years, nearly 90 percent of subprime ARMs used for refinancings were ''cash out.''[10]

While shopping costs are likely clear, the benefits may not be obvious or may appear minimal. Without easy access to subprime product prices, a consumer may have only a limited idea after working with one originator 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.[11] Once approved, these consumers may see little advantage to continuing to shop for better terms if they expect to be turned down by other originators. Further, if a consumer uses a broker believing that the broker is shopping for the consumer for the best deal, the consumer may believe a better deal is not obtainable. 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.[12]

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.[13] 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.[14] 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

financial transactions.''); Howard Lax, Michael Manti, Paul Raca and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency,* 15 Housing Policy Debate 533, 570 (2004) (*Subprime Lending Investigation*) (stating that the subprime market lacks the ''overall standardization of products, underwriting, and delivery systems'' that is found in the prime market).

[8] Data reported by Wholesale Access Mortgage Research and Consulting, Inc., available at *http://www.wholesaleaccess.com/.*

[9] *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).

[10] A ''cash out'' transaction is one in which the borrower refinances an existing mortgage, and the new mortgage amount is greater than the existing mortgage amount, to allow the borrower to extract from the home. Figure calculated from First American LoanPerformance data.

[11] James M. Lacko and Janis K. Pappalardo, Federal Trade Commission, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms* at 24–26 (2007), available at: *http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (Improving Mortgage Disclosures)* (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.'').

[12] *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.'').

[13] Jinkook Lee and Jeanne M. Hogarth, *Consumer Information Search for Home Mortgages: Who, What, How Much, and What Else?*, Financial Services Review 291 (2000) (*Consumer Information Search*) (''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.'').

[14] *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 and Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?* 18–22 (Board 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.*

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 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.[15] If consumers do not have a certain minimum level understanding of the market and products, disclosures for complex and infrequent transactions may not effectively provide that minimum understanding. 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.

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.[16] Therefore, while the Board anticipates proposing changes to Regulation Z to improve mortgage loan disclosures, it is 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 were not adequately assessing repayment ability, particularly where mortgages were sold to the secondary market and the originator retained little of the risk. 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, has also contributed 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.[17]

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 to the loan purchaser. Thus, originators that 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.[18]

Fragmentation in the originator market can further exacerbate the problem. Data reported under the Home Mortgage Disclosure Act (HMDA) show that independent mortgage companies—those not related to depository institutions or their subsidiaries or affiliates—in 2005 and 2006 made nearly one-half of first-lien mortgage loans reportable as being higher-priced but only one-fourth of loans that were not reportable as 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 first-lien mortgage loans on owner-occupied dwellings that were reportable as higher-priced. In addition, as noted earlier, one source suggests that 60 percent or more of mortgages originated in the last several years were originated through mortgage brokers.[19] 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. Further, government oversight of such a fragmented market faces significant challenges because originators operate in different states and under different regulatory and supervisory regimes and different practices in sharing information among regulators. 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 originate are affordable; and regulators face limits on their ability to oversee a fragmented subprime origination market. These circumstances 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 ensures that it is applied uniformly to all originators and provides 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

[15] *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).

[16] 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).

[17] Atif Mian and Amir Sufi, *The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis* (May 2008), available at: *http://ssrn.com/abstract=1072304.*

[18] Benjamin J. Keys, Tanmoy K. Mukherjee, Amit Seru and Vikram Vig, *Did Securitization Lead to Lax Screening? Evidence from Suprime Loans* at 22, available at: *http://ssrn.com/abstract=1093137.*

[19] Data reported by Wholesale Access Mortgage Research and Consulting, Inc., available at *http://www.wholesaleaccess.com.*

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'').[20] 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.[21] 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 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 duty of care 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

[20] 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).

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

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 addressing in these final rules.

D. Congressional Hearings

Congress has also held a number of hearings in the past year about consumer protection concerns in the mortgage market.[22] 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 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. Interagency 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.[23]

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 2007, sets out the standards institutions should follow to ensure borrowers in the subprime market obtain loans they can afford to repay.[24] 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 adopting apply uniformly to all creditors and are 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 §§ 226.35 and 226.36 and corresponding revisions to §§ 226.32 and 226.34, as well as restrictions on misleading and deceptive advertisements, are 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:

[22] *E.g., Foreclosure Problems and Solutions: Federal, State, and Local Efforts to Address the Foreclosure Crisis in Ohio: Hearing before the Subcomm. on Housing and Comm. Oppty. of the H. Comm. on Fin. Servs.,* 110th Cong. (2008); *Targeting Federal Aid to Neighborhoods Distressed by the Subprime Mortgage Crisis: Hearing before the Subcomm. on Housing and Comm. Oppty. of the H. Comm. on Fin. Servs.,* 110th Cong. (2008); *Improving Consumer Protections in Subprime Lending: Hearing before the Subcomm. on Int. Comm., Trade, and Tourism of the S. Comm. on Comm., Sci., and Trans.,* 110th Cong. (2008); *H.R. 5679, The Foreclosure Prevention and Sound Mortgage Servicing Act of 2008: Hearing before the Subcomm. on Housing and Comm. Oppty. of the H. Comm. on Fin. Servs.,* 110th Cong. (2008); *Restoring the American Dream: Solutions to Predatory Lending and the Foreclosure Crisis: S. Comm. on Banking, Hsg., and Urban Affairs,* 110th Cong. (2008); *Consumer Protection in Financial Services: Subprime Lending and Other Financial Activities: Hearing before the Subcomm. on Fin. Svcs. and Gen. Gov't of the H. Approp. Comm.,* 110th Cong. (2008); *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).

[23] Interagency Guidance on Nontraditional Mortgage Product Risks, 71 FR 58609, Oct. 4, 2006 (*Nontraditional Mortgage Guidance*).

[24] Statement on Subprime Mortgage Lending, 72 FR 37569, Jul. 10, 2007 (*Subprime Statement*).

• 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 TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), is broad. It 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. Section 129(l)(2) also authorizes the Board to strengthen the protections in Section 129(c)–(i) for the loans to which Section 103(aa) applies these protections (HOEPA loans). In TILA Section 129 (c)–(i), Congress set minimum standards for HOEPA loans. The Board is authorized to strengthen those standards for HOEPA loans when the Board finds practices unfair, deceptive, or abusive. The Board is also authorized by Section 129(l)(2) to apply those strengthened standards to loans that are not HOEPA loans. Moreover, while HOEPA's statutory restrictions apply only to creditors and only to loan terms or lending practices, Section 129(l)(2) is not limited to acts or practices by 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.'' Thus, the Board's authority is not 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.

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 statutes and the Federal Trade Commission Act (FTC Act), Section 5(a), 15 U.S.C. 45(a).[25]

Congress has codified standards developed by the Federal Trade Commission (FTC) for determining whether acts or practices are unfair under Section 5(a), 15 U.S.C. 45(a).[26] Under the FTC 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.[27]

The FTC has interpreted these standards to mean that consumer injury is the central focus of any inquiry regarding unfairness.[28] 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 concrete harm.[29] The FTC looks to whether an act or practice is injurious in its net effects.[30] 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.[31] In evaluating unfairness, the FTC looks to whether consumers' free market decisions are unjustifiably hindered.[32]

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).[33] 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.[34]

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.[35]

In adopting final 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 these rules 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 requirement to provide early disclosures for residential mortgage transactions as well as many of the revisions to improve advertising disclosures. These rules 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. The Board's Proposal

On January 9, 2008, the Board published a notice of proposed rulemaking in the **Federal Register** (73 FR 1672) proposing to amend Regulation Z.

A. Proposals To Prevent Unfairness, Deception, and Abuse

The Board proposed new restrictions and requirements for mortgage lending and servicing intended to protect consumers against unfairness, deception, and abuse while preserving responsible lending and sustainable homeownership. Some of the proposed restrictions would apply only to higher-priced mortgage loans, while others

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

[26] *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).

[27] 15 U.S.C. 45(n).

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

[29] 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).

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

[31] *Id.*

[32] *Id.*

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

[34] *Dingell Letter* at 1–2.

[35] *See, e.g., Kenai Chrysler Ctr., Inc.* v. *Denison,* 167 P.3d 1240, 1255 (Alaska 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 (N.H. 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).

would apply to all mortgage loans secured by a consumer's principal dwelling.

Protections Covering Higher-Priced Mortgage Loans

The Board proposed certain protections for consumers receiving higher-priced mortgage loans. Higher-priced mortgage loans would have been loans with 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 such loans, the Board proposed 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 have prohibited 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.

Proposed 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 proposed 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 the Board's proposal was to ensure that mortgage loan advertisements provide accurate and balanced information and do not contain misleading or deceptive representations. The Board proposed 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. The proposal was issued under the Board's authorities to: Adopt regulations to ensure consumers are informed about and can shop for credit; require that information, including the information required for advertisements for closed-end credit, be disclosed in a clear and conspicuous manner; and regulate advertisements of open-end home-equity plans secured by the consumer's principal dwelling. *See* TILA Section 105(a), 15 U.S.C. 1604(a); Section 122, 15 U.S.C. 1632; Section 144, 15 U.S.C. 1664; Section 147, 15 U.S.C. 1665b.

The Board also proposed, 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 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 the proposal was to provide consumers transaction-specific disclosures early enough to use while shopping for a mortgage loan. The Board proposed 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 business 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.

VII. Overview of Comments Received

The Board received approximately 4700 comments on the proposal. The comments came from community banks, independent mortgage companies, large bank holding companies, secondary market participants, credit unions, state and national trade associations for financial institutions in the mortgage business, mortgage brokers and mortgage broker trade associations, realtors and realtor trade associations, individual consumers, local and national community groups, federal and state regulators and elected officials, appraisers, academics, and other interested parties.

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

Many commenters supported the approach of using loan price to identify ''higher-priced'' loans. Financial institution commenters and their trade associations were concerned, however, that the proposed price thresholds were too low, and could capture many prime loans. They contended that broad coverage would reduce credit availability because creditors would refrain from making covered loans or would pass on compliance costs. Many industry commenters urged the Board to use a different index to define higher-priced mortgage loans than the proposed index of Treasury security yields, because the spread between Treasury yields and mortgage rates can change. Consumer advocate commenters generally, but not uniformly, favored applying the Board's proposed protections to all loans secured by a principal dwelling regardless of loan price. In the alternative, they favored the proposed price thresholds but urged the Board also to apply the protections to nontraditional mortgage loans.

Industry commenters generally, but not uniformly, supported or did not oppose a rule prohibiting lenders from engaging in a pattern or practice of unaffordable lending. They urged the Board, however, to provide a clear and specific ''safe harbor'' and remove the presumptions of violations in order to avoid unduly constraining credit. In contrast, consumer advocate commenters and others urged the Board to revise the ability to repay rule so that it applies on a loan-by-loan basis and not only to a pattern or practice of disregarding borrowers' ability to repay. These commenters argued that a requirement to prove a ''pattern or practice'' would prevent consumers from bringing claims and would weaken the rule's power to deter abuse.

Consumer advocate commenters and some federal and state regulators and elected officials also maintained that a complete ban on prepayment penalties is necessary to protect consumers. In particular, many of these commenters argued that prepayment penalties' harms to subprime consumers outweigh the benefits of any reductions in interest rate consumers receive, and that the Board's proposed restrictions on prepayment penalties would not adequately address the harms. However, most banks and their trade associations stated that the interest rate benefit afforded to consumers with loans having prepayment penalty provisions lowers credit costs and increases credit availability.

Many community banks and mortgage brokers as well as several industry trade associations opposed the proposed escrow requirement, contending that escrow infrastructures would be costly and that creditors would either refrain from making higher-priced loans or would pass costs on to consumers. Consumers also expressed concern that they would lose interest on their escrowed funds and that servicers would fail to properly pay tax and insurance obligations. Several industry trade associations, several large creditors and some mortgage brokers, consumer and community development groups, and state and federal officials, however, supported the proposed escrow requirement as protecting consumers from expensive force-placed insurance or default, and possibly foreclosure.

For their part, mortgage brokers and their trade associations principally addressed the yield spread premium proposal, which they strongly opposed. They, as well as FTC staff, argued that prohibiting creditors from paying brokers more than the consumer agreed to in writing would put brokers at a competitive disadvantage relative to retail lenders. They also argued that consumers would be confused and misled by a broker compensation disclosure. Consumer advocates, several members of Congress, several state attorneys general, and the FDIC contended that the proposal would do little to protect consumers and urged the Board to ban yield spread premiums outright.

Most commenters generally supported the Board's proposed advertising rules, although some commenters requested clarifications and modifications. Commenters were divided about the proposal to require early mortgage loan disclosures. Many creditors and their trade associations opposed the proposal because of perceived operational cost and compliance difficulties, and concerns about the scope of the fee restriction and its application to third party originators. Consumer groups, state regulators and enforcement generally supported the proposed rule, however, because it would make more information available to consumers when they are shopping for loans. Some of the commenters requested that the Board require lenders to redisclose before loan consummation to enhance the accuracy of information.

Industry commenters urged the Board to adopt all of the proposed restrictions in §§ 226.35 and 226.36 under its TILA Section 105(a) authority rather than its Section 129(l)(2) authority. They argued that using Section 129(l)(2) authority would impose disproportionately heavy penalties on lenders for violations and unnecessary costs on consumers. Consumer advocates, on the other hand, supported using Section 129(l)(2) authority and urged the Board use it more broadly to adopt the other proposed rules concerning early disclosures and advertising.

Public comments with respect to these and other provisions of the rule are described and discussed in more detail below.

VIII. Definition of ''Higher-Priced Mortgage Loan''—§ 226.35(a)

A. Overview

The Board proposed to extend certain consumer protections to a subset of consumer residential mortgage loans referred to as ''higher-priced mortgage loans.'' This part VIII discusses the definition of ''higher-priced mortgage loan'' the Board is adopting. A discussion of the specific protections that apply to these loans follows in part IX. The Board is also finalizing the proposal 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 X.

Under the proposal, 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, and home equity loans. The definition would exclude home equity lines of credit (''HELOCs''). There would also be exclusions for reverse mortgages, construction-only loans, and bridge loans.

The Board is adopting a definition of ''higher-priced mortgage loan'' that is substantially similar to that proposed but different in the particulars. The changes to the final rule are being made in response to commenters' concerns. The final definition, like the proposed definition, sets a threshold above a measure of market rates to distinguish higher-priced mortgage loans from the rest of the mortgage market. But the measure the Board is adopting is different, and therefore so is the threshold. Instead of yields on Treasury securities, the definition uses average offer rates for the lowest-risk prime mortgages, termed ''average prime offer rates.'' For the foreseeable future, the Board will obtain or, as applicable, derive average prime offer rates from the Freddie Mac Primary Mortgage Market Survey®. The threshold is set at 1.5 percentage points above the average prime offer rate on a comparable transaction for first-lien loans, and 3.5 percentage points for subordinate-lien loans. The exclusions from ''higher-priced mortgage loans'' for HELOCs and certain other types of transactions are adopted as proposed.

The definition of ''higher-priced mortgage loans'' appears in § 226.35(a). Such loans are subject to the restrictions and requirements in § 226.35(b) concerning repayment ability, income verification, prepayment penalties, escrows, and evasion, except that only first-lien higher-priced mortgage loans are subject to the escrow requirement.

B. Public Comment on the Proposal

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

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

The proposed exclusion of HELOCs drew criticism from several consumer and civil rights groups but strong support from industry commenters. The other proposed exclusions drew limited comment. Some industry commenters proposed additional exclusions for loans with federal guaranties such as FHA, VA, and Rural Housing Service. A few commenters also proposed excluding ''jumbo'' loans, that is, loans in an amount that exceeds the threshold of eligibility for purchase by Fannie Mae or Freddie Mac. Other proposed exclusions are discussed below.

C. General Approach

Cover Subprime, Exclude Prime

The Board stated in connection with the proposal 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, as it stated in connection with the proposal, that the stricter regulations of § 226.35 should cover the subprime market and generally exclude the prime market.

The Board believes that the practices that § 226.35 would prohibit—lending without regard to ability to pay from verified income and non-collateral assets, failure to establish an escrow for taxes and insurance, and prepayment penalties outside of prescribed limits—are so clearly injurious on balance to consumers within the subprime market that they should be categorically barred in that market. The reasons for this conclusion are detailed below in part IX with respect to each practice. Moreover, the Board has concluded that, to be effective, these prohibitions must cover the entire subprime market and not just subprime products with particular terms or features. Market imperfections discussed in part II—the subprime market's lack of transparency and potentially inadequate incentives for creditors to make only loans that consumers can repay—affect consumers throughout the subprime market. To be sure, risk within the subprime market has varied by loan type. For example, delinquencies on fixed-rate subprime mortgages have been lower in recent years than on adjustable-rate subprime mortgages. It is not likely to be practical or effective, however, to target certain types of loans in the subprime market for coverage while excluding others. Such a rule would be unduly complex, likely fail to adapt quickly enough to ever-changing products, and encourage creditors to steer borrowers to uncovered products.

In the prime market, however, the Board believes that a case-by-case approach to determining whether the § 226.35 practices are unfair or deceptive is more appropriate. By nature, loans in the prime market have a lower credit risk. 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. The final rule applies protections against coercion of appraisers and unfair servicing practices to the prime market because, with respect to these particular practices, the prime market, too, suffers a lack of transparency and these practices do not appear to be limited to the subprime market.

With these limited exceptions, at present the Board believes that any undue risks to consumers in the prime market from particular loan terms or lending practices are better 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.[36] Such guidance affords regulators and institutions alike more flexibility than a regulation, with potentially fewer unintended consequences. In addition, the standards the Government Sponsored Enterprises set for the loans they will purchase continue to have significant influence within the prime market, and these entities are accountable for those standards to regulators and Congress.[37]

Use the APR

The Board also continues to believe—and few, if any, commenters disagreed—that the best way to identify the subprime market is by loan price rather than by 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

[36] 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.

[37] 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. This figure understates the GSEs' influence on the prime market because it excludes the many loans that were underwritten using the GSEs' standards but were not sold to the GSEs.

as the benchmark for a regulation could give unfair advantage to the company that provides that score.

The most appropriate measure of loan price for this regulation is the APR; few, if any, commenters disagreed with this point either. 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. Because 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 § 226.35.

Two loans with identical risk characteristics will likely have different APRs if they were originated when market rates were different. It is important to normalize the APR by an index that moves with mortgage market rates so that loans with the same risk characteristics will be treated the same regardless of when the loans were originated. The Board proposed to use as this index the yields on comparable Treasury securities, which 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 mortgage loans reportable under HMDA as being higher-priced, *see* 12 CFR 203.4(a)(12). For reasons discussed in more detail below, the final rule uses instead an index that more closely tracks movements in mortgage rates than do Treasury yields.

Uncertainty

As the Board stated in connection with the proposal, 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 not a 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 provide only a rough measure of the empirical relationship between APR and credit risk. A proprietary dataset such as the loan-level data on subprime securitized mortgages published by 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 mortgage loans reportable as being higher-priced (as adjusted by comparable Treasury securities), but they have little information about credit risk.

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. ''Over compliance'' could effectively lower the threshold. While a loan's APR can be estimated early in the application process, it is typically not known to a certainty until after the underwriting has been completed and the interest rate has been locked. 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 contract rates and points that are economically identical for an originator produce different APRs. With the adoption of § 226.35, an originator may 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 perfectly achieve the objectives of covering the subprime market and generally excluding the prime market. In the face of this uncertainty, deciding on an APR threshold calls for judgment. As the Board stated with the proposal, the Board believes it is appropriate to err on the side of covering somewhat more than the subprime market.

The Alt-A Market

If the selected thresholds cover more than the subprime market, then they likely extend into what has been known as the alt-A market. 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.

The Board judges that the benefits of extending § 226.35's restrictions into some part of the alt-A market to ensure coverage of the entire subprime market outweigh the costs. This market segment also saw undue relaxation of underwriting standards, one reason that its share of residential mortgage originations grew sixfold from 2003 to 2006 (from two percent of originations to 13 percent). [38] *See* part VIII.C for further discussion of the relaxation of underwriting standards in the alt-A market.

To the extent § 226.35 covers the higher-priced end of the alt-A market, where risks in that segment are highest, the regulation will likely benefit consumers more than it would cost them. Prohibiting lending without regard to repayment ability in this market slice would likely reduce the risk to consumers from ''payment shock'' on nontraditional loans. Applying the income verification requirement of §§ 226.32(a)(4)(ii) and 226.35(b)(1) 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.

D. Index for Higher-Priced Mortgage Loans

Under the proposal, 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 home purchase loans, and home equity

[38] *IMF 2007 Mortgage Market* at 4.

loans. The definition would exclude home equity lines of credit (''HELOCs''), reverse mortgages, construction-only loans, and bridge loans.

The Board is adopting a definition of ''higher-priced mortgage loan'' that is substantially similar to that proposed but different in the particulars. The final definition, like the proposed definition, sets a threshold above a measure of market rates to distinguish higher-priced mortgage loans from the rest of the mortgage market. But the measure the Board is adopting is different, and therefore so is the threshold. Instead of yields on Treasury securities, the final definition uses average offer rates for the lowest-risk prime mortgages, termed ''average prime offer rates.'' For the foreseeable future, the Board will obtain or, as applicable, derive average prime offer rates for a wide variety of types of transactions from the Primary Mortgage Market Survey® (PMMS) conducted by Freddie Mac, and publish these rates on at least a weekly basis. The Board will conduct its own survey if it becomes appropriate or necessary to do so. The threshold is set at 1.5 percentage points above the average prime offer rate on a comparable transaction for first-lien loans, and 3.5 percentage points for subordinate-lien loans. The exclusions from ''higher-priced mortgage loans'' for HELOCs and certain other types of transactions are adopted as proposed.

Public Comment

A large number and wide variety of industry commenters, as well as a consumer research and advocacy group, urged the Board to use a prime mortgage market rate instead of, or in addition to, Treasury yields. First, they argued the tendency of prime mortgage rates at certain times to deviate significantly from Treasury yields—such as during the ''flight to quality'' seen in recent months—would lead to unwarranted coverage of the prime market and arbitrary swings in coverage. Many of these commenters also pointed out that changes in the Treasury yield curve (the relationship of short-term to long-term Treasury yields) can increase or decrease coverage even though neither borrower risk profiles nor creditor practices or products have changed. The Board's proposal to address this second problem by matching Treasuries to mortgages on the basis of the loan's expected life span drew limited, but mostly negative, comment. Although one large lender specifically agreed with the proposed matching rules, a few others stated the rules were too complicated.

The precise recommendations for a measure of mortgage market rates varied. Several commenters specifically recommended using the PMMS. They recommended that a threshold be added to the PMMS figure because it is, by design, at the low end of the range of rates that can be found in the prime market. Recommendations for thresholds for first-lien loans ranged from 150 to 300 basis points over the PMMS. Some commenters recommended approaches that would rely on both Treasuries and the PMMS. A few recommended the approach of a recent North Carolina law, which covers a first-lien loan only if its APR exceeds two thresholds: 300 basis points over the comparable Treasury yield and 175 basis points over the PMMS rate for the 30-year fixed-rate loan. A few recommended a different way to integrate Treasuries and the PMMS. Under this approach, the threshold would be set at the comparable Treasury yield (determined as proposed) plus 200 basis points (400 for subordinate-lien loans), plus the spread between the PMMS 30-year FRM rate and the seven-year Treasury.

Some commenters offered alternatives to the PMMS. A consumer research and advocacy group and Freddie Mac suggested that the Board could use the higher of the Freddie Mac Required Net Yield (the yield Freddie Mac expects from purchasing a conforming mortgage) and the equivalent Fannie Mae yield. Fannie Mae offered a similar, but not identical, recommendation to use the higher of the current coupon yield for Fannie Mae Mortgage Backed Securities and Freddie Mac participation certifications (PC). These yields reflect the price at which a government-sponsored entity (GSE) security can be sold in the market. At least one commenter suggested that the Board could conduct its own survey of mortgage market rates.

Discussion

Based on these comments and the analysis below, the final rule does not use Treasury yields as the index for higher-priced mortgage loans. Instead, the rule uses average offer rates on the lowest-risk prime mortgage loans, termed ''average prime offer rates.'' For the foreseeable future, the Board will obtain or, as applicable, derive these rates for a wide variety of types of transactions from the PMMS and publish them on a weekly basis.

Drawbacks of using Treasury security yields. There are significant advantages to using Treasury yields to set the APR thresholds. Treasuries are traded in a highly liquid market; Treasury yield data are published for many different maturities and can easily be calculated for other maturities; and the integrity of published yields is not subject to question. For these reasons, Treasuries are also commonly used in federal statutes, such as HOEPA, for benchmarking purposes.

As recent events have highlighted, however, using Treasury yields to set the APR threshold in a law regulating mortgage loans has two major disadvantages. The most significant disadvantage is that the spread between Treasuries and mortgage rates, even prime mortgage rates, changes in the short term and in the long term. Moreover, the comparable Treasury security for a given mortgage loan is quite difficult to determine accurately.

The Treasury-mortgage spread can change for at least three different reasons. First, credit risk may change on mortgages, even for the highest-quality borrowers. For example, credit risk increases when house prices fall. Second, competition for prime borrowers can increase, tightening spreads, or decrease, allowing lenders to charge wider spreads. Third, movements in financial markets can affect Treasury yields but have no effect on lenders' cost of funds or, therefore, on mortgage rates. For example, Treasury yields fall disproportionately more than mortgage rates during a ''flight to quality.''

Recent events illustrate how much the Treasury-mortgage spread can swing. The spread averaged about 170 basis points in 2007, but increased to an average of about 220 basis points in the first half of 2008. In addition, the spread was highly volatile in this period, shifting as much as 25 basis points in a week. The spread may decrease, but predictions of long-term spreads are highly uncertain.

Changes in the Treasury-mortgage spread can undermine key objectives of the regulation. These changes mean that loans with identical credit risk are covered in some periods but not in others, contrary to the objective of consistent and predictable coverage over time. Moreover, lenders' uncertainty as to when such changes will occur can cause them to set an internal threshold below the regulatory threshold. This may reduce credit availability directly (if a lender's policy is not to make higher-priced mortgage loans) or indirectly, by increasing regulatory burden. The recent volatility might lead lenders to set relatively conservative cushions.

Adverse consequences of volatility in the spread between mortgages rates and Treasuries could be reduced simply by setting the regulatory threshold at a high enough level to ensure it excludes all prime loans. But a threshold high enough to accomplish this objective would likely fail to meet another, equally important objective of covering essentially all of the subprime market. Instead, the Board is adopting a rate that closely follows mortgage market rates, which should mute the effects on coverage of changes in the spread between mortgage rates and Treasury yields.

The second major disadvantage of using Treasury yields to set the threshold is that the comparable Treasury security for a given mortgage loan is quite difficult to determine accurately. Regulation C determines the comparable Treasury security on the basis of contractual maturity: A loan is matched to a Treasury with the same contract term. For example, the regulation matches a 30-year mortgage loan to a 30-year Treasury security. This method does not, however, account for the fact that very few loans reach their full maturity, and it causes significant distortions when the yield curve changes shape.[39] These distortions can bias coverage, sometimes in unpredictable ways, and consequently might influence the preferences of lenders to offer certain loan products in certain environments. For example, a steep yield curve will create two regulatory forces pushing the subprime market toward ARMs: A lender could avoid coverage on the margins by selling ARMs rather than fixed-rate mortgages, and the consumer would receive an APR that understates the interest rate risk from an ARM relative to that from a fixed-rate mortgage. (Regulation Z requires the APR be calculated as if the index does not change; a steep yield curve indicates that the index will likely rise.) Artificial regulatory incentives to increase ARMs production in the subprime market could undermine consumer protection.

The Board proposed to reduce distortions in coverage resulting from changes in the yield curve by matching loans to Treasury securities on the basis of the loan's expected life span rather than its legal term to maturity. For example, the Board proposed to match a 30-year fixed-rate mortgage loan to a 10-year Treasury security on the supposition that the mortgage loan will prepay (or default) in ten years or less. A limitation of this approach is that loan life spans change as rates of house price appreciation, mortgage rates, and macroeconomic factors such as unemployment rates change. Loan life spans also change as specific loan features that influence default or prepayment rates change, such as prepayment penalties. The challenge of adjusting the regulation's matching rules on a timely basis would be substantial, and too-frequent adjustments would complicate creditors' compliance. Indeed, many commenters judged the proposed matching rules to be too complicated. This matching problem can be reduced, if not necessarily eliminated, by using mortgage market rates instead of Treasury security yields to set the threshold.

A rate from the prime mortgage market. To address the principal drawbacks of Treasury security yields, the Board is adopting a final rule that relies instead on a rate that more closely tracks rates in the prime mortgage market. Section 226.35(a)(2) defines an ''average prime offer rate'' as an annual percentage rate derived from average interest rates, points, and other pricing terms offered by a representative sample of creditors for mortgage transactions that have low-risk pricing characteristics. Comparing a transaction's annual percentage rate to this average offered annual percentage rate, rather than to an average offered contract interest rate, should make the rule's coverage more accurate and consistent. A transaction is a higher-priced mortgage loan if its APR exceeds the average prime offer rate for a comparable transaction by 1.5 percentage points, or 3.5 percentage points in the case of a subordinate-lien transaction. (The basis for selecting these thresholds is explained further in part VIII.E) The creditor uses the most recently available average prime offer rate as of the date the creditor sets the transaction's interest rate for the final time before consummation.

To facilitate compliance, the final rule and commentary provide that the Board will derive average prime offer rates from survey data according to a methodology it will make publicly available, and publish these rates in a table on the Internet on at least a weekly basis. This table will indicate how to identify a comparable transaction.

As noted above, the survey the Board intends to use for the foreseeable future is the PMMS, which contains weekly average rates and points offered by a representative sample of creditors to prime borrowers seeking a first-lien, conventional, conforming mortgage and who would have at least 20 percent equity. The PMMS contains pricing data for four types of transactions: ''1-year ARM,'' ''5/1-year ARM,'' ''30-year fixed,'' and ''15-year fixed.'' For the two types of ARMs, PMMS pricing data are based on ARMs that adjust according to the yield on one-year Treasury securities; the pricing data include the margin and the initial rate (if it differs from the sum of the index and margin). These data are updated every week and are published on Freddie Mac's Web site.[40]

The Freddie Mac PMMS is the most viable option for obtaining average prime offer rates. This is the only publicly available data source that has rates for more than one kind of fixed-rate mortgage (the 15-year and the 30-year) and more than one kind of variable-rate mortgage (the 1-year ARM and the 5/1 ARM). Having rates on at least two fixed-rate products and at least two variable-rate products supplies a firmer basis for estimating rates for other fixed-rate and variable-rate products (such as a 20-year fixed or a 3/1 ARM).

Other publicly available surveys the Board considered are less suitable for the purposes of this rule. Only one ARM rate is collected by the Mortgage Bankers Association's Weekly Mortgage Applications Survey and the Federal Housing Finance Board's Monthly Survey of Interest Rates and Terms on Conventional Single-Family Non-Farm Mortgage Loans. Moreover, the FHFB Survey has a substantial lag because it is monthly and reports rates on closed loans. The Board also evaluated two non-survey options involving Fannie Mae and Freddie Mac. One is the Required Net Yield, the prices these institutions will pay to purchase loans directly. The other is the yield on mortgage-backed securities issued by Fannie Mae and Freddie Mac. With either option, data for ARM yields would be difficult to obtain.

These other data sources, however, provide useful benchmarks to evaluate the accuracy of the PMMS. The PMMS has closely tracked these other indices, according to a Board staff analysis. The Board will continue to use them periodically to help it determine whether the PMMS remains an appropriate data source for Regulation Z. If the PMMS ceases to be available, or if circumstances arise that render it unsuitable for this rule, the Board will consider other alternatives including conducting its own survey.

The Board will use the pricing terms from the PMMS, such as interest rate and points, to calculate an annual percentage rate (consistent with Regulation Z, § 226.22) for each of the four types of transactions that the

[39] Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data*, 92 Fed. Res. Bulletin A123–66 (Sept. 8, 2006).

[40] *See http://www.freddiemac.com/dlink/html/PMMS/display/PMMSOutputYr.jsp.*

PMMS reports. These annual percentage rates are the average prime offer rates for transactions of that type. The Board will derive annual percentage rates for other types of transactions from the loan pricing terms available in the survey. The method of derivation the Board expects to use is being published for comment in connection with the simultaneously proposed revisions to Regulation C. When finalized, the method will be published on the Internet along with the table of annual percentage rates.

E. Threshold for Higher-Priced Mortgage Loans

The Board proposed a threshold of three percentage points above the comparable Treasury security for first-lien loans, or five percentage points for subordinate-lien loans. Since the final rule uses a different index, it must also use a different threshold. The Board is adopting a threshold for first-lien loans of 1.5 percentage points above the average prime offer rate for a comparable transaction, and 3.5 percentage points for second-lien loans.

Public Comment

Industry commenters consistently contended that, should the Board use Treasury yields as proposed, thresholds of 300 and 500 basis points would be too low to meet the Board's stated objective of excluding the prime market.[41] These commenters recommended thresholds of 400 basis points (600 for subordinate-lien loans) or higher, but a few trade associations recommended 500 (700) or 600 (800). These commenters contended that covering any part of the prime market would harm consumers because the secondary market would not purchase loans with rates over the threshold. They also stated that many originators would seek to avoid originating such loans because of a stigma these commenters expect will attach to such loans, the increased compliance cost associated with the proposed regulations, and the substantial monetary recovery TILA Section 130 would provide plaintiffs for violations of the regulations.

A trade association for the manufactured housing industry submitted that the proposed thresholds would cover a substantial majority of personal property loans used to purchase manufactured homes. This commenter contended that the reasons these loans are priced higher than loans secured by real estate (such as the smaller loan amounts and the lack of real property securing the loan) do not support a rule that would cover personal property loans disproportionately.

Consumer and civil rights group commenters generally, but not uniformly, opposed limiting protections to higher-rate loans and recommended applying these protections to all loans secured by a principal dwelling. They recommended in the alternative that the thresholds be adopted at the levels proposed or even lower. They argued it was critical to cover all of the subprime market and much if not all of the alt-A market.

Discussion

As discussed above, the Board has concluded that the stricter regulations of § 226.35 should cover the subprime market and generally exclude the prime market; and in the face of uncertainty it is appropriate to err on the side of covering somewhat more than the subprime market. Based on available data, it appeared that the thresholds the Board proposed would capture all of the subprime market and a portion of the alt-A market.[42] Based also on available data, the Board believes that the thresholds it is adopting would cover all, or virtually all, of the subprime market and a portion of the alt-A market. The Board considered loan-level origination data for the period 2004 to 2007 for subprime and alt-A securitized pools. The proprietary source of these data is FirstAmerican Loan Performance.[43] The Board also ascertained from a proprietary database of mostly prime loans (McDash Analytics) that coverage of the prime market during the first three quarters of 2007 at these thresholds would have been very limited. The Board recognizes that the recent mortgage market disruption began at the end of this period, but it is the latest period for which data were available.

The Board is adopting a threshold for subordinate-lien loans of 3.5 percentage points. This is consistent with the Board's proposal to set the threshold over Treasury yields for these loans two percentage points above the threshold for first-lien loans. With rare exceptions, commenters explicitly endorsed, or at least did not raise any objection to, this approach. The Board recognizes that it would be preferable to set a threshold for second-lien loans above a measure of market rates for second-lien loans, but it does not appear that a suitable measure of this kind exists. Although data are very limited, the Board believes it is appropriate to apply the same difference of two percentage points to the thresholds above average prime offer rates.

As discussed earlier, the Board recognizes that there are limitations to making judgments about the future scope of the rule based on past data. For example, when the final rule takes effect, the risk premiums for alt-A loans compared to the conforming loans in the PMMS may be higher than the risk premiums for the period 2004–2007. In that case, coverage of alt-A loans would be higher than an estimate for that period would indicate.

Another important example is prime ''jumbo'' loans, or loans extended to borrowers with low-risk mortgage

[41] One trade association reported that some of its members found the proposal would have covered up to one-third of prime loans originated between November 2007 and January 2008. This and other commenters said the effect was particularly pronounced with ARMs. Several members of this association were reported to have found that more than one-half of prime 7/1, 5/1, and 3/1 ARMs originated between November 2007 and January 2008 would have been covered. A different association of mortgage lenders indicated that some of its members had found that almost 20 percent of prime and alt-A loans would be covered under the proposal, though the time frame its members used was not specified. A major lender reported that the proposal would have captured 8–10 percent of its portfolio in 2006 and 2007, about twice the portion of its portfolio that it was required to report as higher-priced under HMDA. The lender represents that it did not make subprime loans in this period and asserts that its figures are predictive of the impact the proposal would have on the prime market overall. Another large lender that stated it does not make subprime loans believes that about 10 percent of its current originations would fall above the proposed thresholds. One lender, however, expressed satisfaction with the proposed 300 basis points for first-lien loans and said an internal analysis of historical data found it would not have captured significant numbers of its prime loans. But this lender's analysis found that significant numbers of prime subordinate-lien loans would have been captured, leading the lender to recommend raising the threshold for subordinate-lien loans to 600 basis points.

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

[43] Annual percentage rates were estimated from the contract rates in these data using formulas derived from a separate proprietary database of subprime loans that collects contract rates, points, and annual percentage rates. This separate database, which contains data on the loan originations of eight subprime mortgage lenders, is maintained by the Financial Services Research Program at George Washington University.

pricing characteristics, but in amounts that exceed the threshold for loans eligible for purchase by Freddie Mac or Fannie Mae. The PMMS collects pricing data only on loans eligible for purchase by one of these entities (''conforming loans''). Prime jumbo loans have always had somewhat higher rates than prime conforming loans, but the spread has widened significantly and become much more volatile since August 2007. If this spread remains wider and more volatile when the final rule takes effect, the rule will cover a significant share of transactions that would be prime jumbo loans. While covering prime jumbo loans is not the Board's objective, the Board does not believe that it should set the threshold at a higher level to avoid what may be only temporary coverage of these loans relative to the long time horizon for this rule.

A third example is a request from a trade association for the manufactured housing industry, including lenders specializing in this industry, that the thresholds be set higher for loans secured by dwellings deemed to be personal property. This association pointed to the higher risk creditors bear on these loans compared to loans secured by real property, which makes their rates systematically higher for reasons apart from the risks they pose to consumers. It also maintained that such loans have not been associated with the abusive practices of the subprime market.[44]

Credit risk and liquidity risk can vary by many factors, including geography, property type, and type of loan. This may suggest to some that different thresholds should be applied to different classes of transactions. This approach would make the regulation inordinately complicated and subject it to frequent revision, which would not be in the interest of creditors, investors, or consumers. Although the simpler approach the Board is adopting—just two thresholds, one for first-lien loans and another for subordinate-lien loans—has its disadvantages, the Board believes they are outweighed by its benefits of simplicity and stability.

F. The Timing of Setting the Threshold

The Board proposed to set the threshold for a dwelling-secured mortgage loan as of the application date. Specifically, a creditor would use the Treasury yield as of the 15th of the month preceding the month in which the application is received. The Board noted that inconsistency with Regulation C, which sets the threshold as of the 15th of the month before the rate is locked, could increase regulatory burden. The Board suggested, however, that setting the threshold as of the application date might 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.

Very few commenters addressed the precise issue. A couple of them specifically advocated using the rate lock date to select the Treasury yield, as in Regulation C, rather than the application date. Subsequent outreach by the Board indicated that there are different views as to which date to use. Some parties prefer the rate lock date because it is more accurate and therefore would minimize coverage of loans that are not intended to be covered and maximize coverage of loans that are intended to be covered. Other parties prefer the application date because they believe it increases the creditor's ability to predict, when underwriting the loan, that the loan is, or is not, covered by § 226.35.

As noted above, the final rule requires the creditor to use the rate lock date, the date the rate is set for the final time before consummation, rather than the application date. Using the application date might increase the predictability of coverage at the time of underwriting. Using the rate lock date would increase the accuracy of coverage at least somewhat. On balance, the Board believes it is more important to maximize coverage accuracy.

G. Proposal To Conform Regulation C (HMDA)

Regulation C, which implements HMDA, requires creditors to report price data on higher-priced mortgage loans. A creditor reports the difference between a loan's annual percentage rate and the yield on Treasury securities having comparable periods of maturity, if that difference is at least three percentage points for first-lien loans or at least five percentage points for subordinate-lien loans. 12 CFR 203.4(a)(12). Many commenters suggested that the Board establish a uniform definition of ''higher-priced mortgage loan'' for purposes of Regulation C and Regulation Z. Having a single definition would reduce regulatory burden and make the HMDA data a more useful tool to evaluate effects of Regulation Z. Moreover, the Board adopted Regulation C's requirement to report certain mortgage loans as being higher-priced with an objective of covering the subprime market and exclude the prime market, and the definition of ''higher-priced mortgage loan'' adopted in this rule better achieves this objective than the definition in Regulation C for the reasons discussed in part VIII.D. Accordingly, in a separate notice published simultaneously with this final rule the Board is proposing to amend Regulation C to apply the same index and threshold adopted in § 226.35(a).

H. Types of Loans Covered Under § 226.35

The Board proposed 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. This would include home purchase loans, refinancings, 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. In these respects, the rule is adopted as proposed.

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 final rule applies 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 proposed to use its authority under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), to apply the protections of § 226.35 to home purchase loans as well. Commenters did not object, and the Board is adopting the proposal. Covering only refinancings of home purchase loans would fail to protect consumers adequately. From 2003 through the first half of 2007, 42 percent of the higher-risk ARMs that came to dominate the subprime market in recent years were extended to

[44] The specific concern of the commenter is with the requirement to escrow, not, apparently, with the other requirements for higher-priced loans. As discussed in part IX.D, the Board is providing creditors two years to comply with the escrow requirement for manufactured home loans.

consumers to purchase a home.[45] Delinquencies on subprime ARMs used for home purchase have risen more sharply than 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.

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

As proposed, § 226.35 protections are limited 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 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.

A loan to a consumer to purchase or improve a second home would not be covered by these protections unless the loan was secured by the consumer's principal dwelling. Loans primarily for a real estate investment purpose also are not covered. This exclusion is consistent with TILA's focus on consumer-purpose transactions 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 concern than a Board regulation.

Coverage of Nontraditional Mortgages

Under the final rule, nontraditional mortgage loans, which permit non-amortizing payments or negatively amortizing payments, are covered by § 226.35 if their APRs exceed the threshold. Several consumer and civil rights groups, and others, contended that § 226.35 should cover nontraditional mortgage loans regardless of loan price because of their potential for significant payment shock and other risks that led the federal banking agencies to issue the Nontraditional Mortgage Guidance. The Board does not believe that the enhanced protections of § 226.35 should be applied on the basis of product type, with the limited exception of the narrow exemptions for HELOCs and other loan types the Board is adopting. A rule based on product type would need to be reexamined frequently as new products were developed, which could undermine the market by making the rule less predictable. Moreover, it is not clear what criteria the Board would use to decide which products were sufficiently risky to warrant categorical coverage. The Board believes that other tools such as supervisory guidance provide the requisite flexibility to address particular product types when that becomes necessary.

HELOC Exemption

The Board proposed to exempt HELOCs largely for two reasons. First, the Board noted that 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. Second, 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.[46] The Board also pointed to TILA and Regulation Z's special protections for borrowers with HELOCs such as restrictions on changing plan terms.

Several national trade associations and a few large lenders voiced strong support for excluding HELOCs, generally for the reasons the Board cited. Several consumer and civil rights groups disagreed, contending that enough HELOCs are securitized to raise doubts that the originator's interests are sufficiently aligned with the borrower's interests. They maintained that Regulation Z disclosures and limitations for HELOCs are not adequate to protect consumers, and pointed to specific cases in which unaffordable HELOCs had been extended. Other commenters, such as an association of state regulators, agreed that HELOCs should be covered. Commenters offered very few concrete suggestions, however, for how to determine which HELOCs would be covered, such as an index and threshold.

The Board is adopting the proposal for the reasons stated. The Board recognizes, however, that HELOCs present a risk of circumvention. Creditors may seek to evade limitations on closed-end transactions by structuring such transactions as open-end transactions. In § 226.35(b)(5), discussed below in part IX.E, the Board prohibits structuring a closed-end loan as an open-end transaction for the purpose of evading the new rules in § 226.35.

Other Exemptions Adopted

The other proposed exclusions drew limited comment. A couple of commenters expressed support for excluding reverse mortgages while a couple of commenters opposed it. A few large lenders voiced support for excluding construction-only loans. A few commenters voiced support for the exclusion of temporary bridge loans of 12 months or less, and none of the commenters seemed to oppose it. The Board is adopting the proposed exclusions for reverse mortgages, construction-only loans, and temporary or bridge loans of 12 months or less.

[45] Figure calculated from First American LoanPerformance data.

[46] Interagency Credit Risk Guidance for Home Equity Lending, SR 05–11 (May 16, 2005), available at *http://www.federalreserve.gov/boarddocs/srletters/2005/sr0511a1.pdf.*; Addendum to Credit Risk Guidance for Home Equity Lending, SR 06–15 (Sept. 29, 2006), available at *http://www.federalreserve.gov/BoardDocs/SRLetters/2006/SR0615a3.pdf.*

Reverse mortgages. The Board is keenly aware of consumer protection concerns raised by the expanding market for reverse mortgages, which are complex and are sometimes marketed with other complex financial products. Unique aspects of reverse mortgages—for example, the borrower's repayment ability is based on the value of the collateral rather than on income—suggest that they should be addressed separately from this final rule. The Board is reviewing this segment of the mortgage market in connection with its comprehensive review of Regulation Z to determine what measures may be required to ensure consumers are protected.

Construction-only loans. Section 226.35 excludes 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 does 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 depending on its APR. 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

Bridge loans. 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 for bridge loans from the restrictions of § 226.35, as they apply to HOEPA loans, would be in borrowers' interest and support homeownership.

The final rule, like the proposed rule, gives as an example of a ''temporary or bridge loan'' a loan to purchase a new dwelling where the consumer plans to sell a current dwelling within 12 months. This is not the only potential *bona fide* example of a temporary or bridge loan. The Board does expect, however, that the temporary or bridge loan exemption will be applied narrowly and not to evade or circumvent the regulation. For example, a 12-month loan with a substantial balloon payment would not qualify for the exemption where it was clearly intended to lead a borrower to refinance repeatedly into a chain of 12-month loans.

Exemptions Not Adopted

Industry commenters proposed additional exclusions that the Board is not adopting.

Government-guaranteed loans. Some commenters proposed excluding loans with federal guaranties such as FHA, VA, and Rural Housing Service. They suggested that the federal regulations that govern these loans are sufficient to protect consumers, and that new regulations under HOEPA were not only unnecessary but could cause confusion. At least one commenter also suggested excluding loans with state or local agency guaranties.

The Board does not believe that exempting government-guaranteed loans from § 226.35 is appropriate. It is not clear what criteria the Board would use to decide precisely which government programs would be exempted; commenters did not offer concrete suggestions. Moreover, such exemptions could attract to agency programs less scrupulous originators seeking to avoid HOEPA's civil liability, with serious unintended consequences for consumers as well as for the agencies and taxpayers.

Jumbo loans. A few commenters proposed excluding non-conforming or ''jumbo'' loans, that is, loans that exceed the threshold amount for eligibility for purchase by Fannie Mae or Freddie Mac. They cited a lack of evidence of widespread problems with jumbo loan performance, and a belief that borrowers who can afford jumbo loans are more sophisticated consumers and therefore better able to protect themselves.

The Board does not believe excluding jumbo loans would be appropriate. The request is based on certain assumptions about the characteristics of the borrowers who take out jumbo loans. In fact, jumbo loans are offered in the subprime and alt-A markets and not just in the prime market. A categorical exemption of jumbo loans could therefore seriously undermine protections for consumers, especially in areas with above-average home prices.

Portfolio loans. A commenter proposed excluding loans held in portfolio on the basis that a lender will take more care with these loans. Among other concerns with such an exemption is that it often cannot be determined as of consummation whether a loan will be held in portfolio or sold immediately—or, if held, for how long before being sold. Therefore, such an exception to the rule does not appear practicable and could present significant opportunities for evasion.

IX. Final Rules for Higher-Priced Mortgage Loans and HOEPA Loans

A. Overview

This part discusses the new consumer protections the Board is applying to ''higher-priced mortgage loans'' and HOEPA loans. Creditors are prohibited from extending credit without regard to borrowers' ability to repay from sources other than the collateral itself. The final rule differs from the proposed rule in that it removes the proposed ''pattern or practice'' phrase and adds a presumption of compliance when certain underwriting procedures are followed. Creditors are also required to verify income and assets they rely upon to determine repayment ability, and to establish escrow accounts for property taxes and insurance. In addition, a higher-priced mortgage loan may not have a prepayment penalty except under certain conditions. These conditions are substantially narrower than those proposed.

The Board finds that the prohibitions in the final rule are necessary to prevent practices that the Board finds to be unfair, deceptive, associated with abusive lending practices, or 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.

The Board is also adopting the proposed rule prohibiting 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 rule 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 Consumer's 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) prohibit a pattern or practice of extending credit subject to § 226.32 (HOEPA loans) based on consumers' collateral without regard to their repayment ability. The regulation creates a presumption of a violation where a creditor has a pattern or practice of failing to verify and document repayment ability. The Board proposed to revise the prohibition on disregarding repayment ability and extend it, through proposed § 226.35(b)(1), to higher-priced mortgage loans as defined in § 226.35(a). The proposed revisions included adding several rebuttable presumptions of violations for a pattern or practice of failing to follow certain underwriting procedures, and a safe harbor.

The final rule removes ''pattern or practice'' and therefore prohibits any HOEPA loan or higher-priced mortgage loan from being extended based on the collateral without regard to repayment ability. Verifying repayment ability has been made a requirement rather than a presumptive requirement. The proposal provided that a failure to follow any one of several specified underwriting procedures would create a presumption of a violation. In the final rule, those procedures, with modifications, have instead been incorporated into a presumption of compliance which replaces the proposed safe harbor.

Public Comment

Mortgage lenders and their trade associations that commented generally, but not uniformly, support or at least do not oppose a rule requiring creditors to consider repayment ability. They maintain, however, that the rule as drafted would unduly constrain credit availability because of the combination of potentially significant damages under TILA Section 130, 15 U.S.C. 1640, and a perceived lack of a clear and flexible safe harbor. These commenters stated that two elements of the rule that the Board had intended to help preserve credit availability—the ''pattern or practice'' element and a safe harbor for a creditor having a reasonable expectation of repayment ability for at least seven years—would not have the intended effect. Many of these commenters suggested that the rule would unduly constrain credit unless the Board removed the presumptions of violations and provided a clearer and more specific safe harbor. Some of these commenters also requested additional safe harbors, such as for use of an automated underwriting system (AUS) of Fannie Mae or Freddie Mac.

Consumer, civil rights, and community development groups, as well as some state and local government officials, several members of Congress, a federal regulator, and others argued that ''pattern or practice'' seriously weakened the rule and urged its removal. They maintain that ''pattern or practice'' would effectively prevent an individual borrower from bringing a claim or counter-claim based on his or her loan, and reduce the rule's deterrence of irresponsible lending. These commenters generally support the proposed presumptions of violations but many of them urged the Board to adopt quantitative standards for the proposed presumptions for failing to consider debt-to-income ratios (DTI) and residual income levels. As discussed above, these commenters also would apply the rule to nontraditional mortgages regardless of price, and a few would apply the rule to the entire mortgage market including the prime market.

The comments are discussed in more detail throughout this section as applicable.

Discussion

The Board finds that disregarding a consumer's repayment ability when extending a higher-priced mortgage loan or HOEPA loan, or failing to verify the consumer's income, assets, and obligations used to determine repayment ability, are unfair practices. This section discusses the evidence from recent events of a disregard for repayment ability and reliance on unverified incomes in the subprime market; the substantial injuries that disregarding repayment ability and failing to verify income causes consumers; the reasons consumers cannot reasonably avoid these injuries; and the Board's basis for concluding that the injuries are not outweighed by countervailing benefits to consumers or competition when repayment ability is disregarded or income is not verified.

Evidence of a recent widespread disregard of repayment ability. Approximately three-quarters of securitized originations in subprime pools from 2003 to 2007 were 2–28 or 3–27 ARMs with a built-in potential for significant payment shock at the start of the third or fourth year, respectively.[47] Originations of these types of mortgages during 2005 and 2006 and through early 2007 have contributed significantly to a substantial increase in serious delinquencies and foreclosures. 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.[48] Adjustable-rate subprime mortgages reached a serious delinquency rate of almost 28 percent in May 2008, quintuple the mid-2005 level. The serious delinquency rate has also risen for loans in alt-A (near prime) securitized pools to almost 8 percent (as of April 2008) from less than 2 percent only a year ago. In contrast, 1.5 percent of loans in the prime-mortgage sector were seriously delinquent as of April 2008.

Higher delinquencies have shown through to foreclosures. Foreclosures were initiated on some 1.5 million U.S. homes during 2007, up 53 percent from 2006, and the rate of foreclosure starts looks to be higher yet for 2008. Lenders initiated over 550,000 foreclosures in the first quarter of 2008, about 274,000 of them on subprime mortgages. This was significantly higher than the quarterly average of 440,000 foreclosures in the second half of 2007 and 325,000 in the first half, and twice the quarterly average of 225,000 for the past six years.[49]

Payment increases on 2–28 and 3–27 ARMs have not been a major cause of the increase in delinquencies and foreclosures because most delinquencies occurred before the payments were adjusted. Rather, a major contributor to these delinquencies was lenders' extension of credit on the basis of income stated on applications without verification.[50] Originators had strong incentives to make these ''stated income'' loans, and consumers had incentives to accept them. Because the loans could be originated more quickly, originators, who were paid based on volume, could increase their earnings by originating more of them. 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.[51] The prevalence of stated income lending left wide room for the loan officer, mortgage broker, or consumer to overstate the consumer's income so the consumer could qualify for a larger loan

[47] 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. 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).

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

[49] Estimates are based on data from *MBA Nat'l Delinquency Survey.*

[50] *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).

[51] Figures calculated from First American LoanPerformance data.

and the loan officer or broker could receive a larger commission. There is substantial anecdotal evidence that borrower incomes were commonly inflated.[52]

Lenders relying on overstated incomes to make loans could not accurately assess consumers' repayment ability.[53] Evidence of this failure is found in the somewhat steeper increase in the rate of default for low/no doc loans originated when underwriting standards were declining in 2005 and 2006 relative to full documentation loans.[54] Due in large part to creditors' reliance on inaccurate ''stated incomes,'' lenders often failed to determine reliably that the consumer would be able to afford even the initial discounted payments. Almost 13 percent of the 2–28 ARMs originated in 2005 appear to have become seriously delinquent before their first reset.[55] While some of these borrowers may have been able to make their payments—but stopped because their home values declined and they lost what little equity they had—others were not able to afford even their initial payments.

Although payment shock on 2–28 and 3–27 ARMs did not contribute significantly to the substantial increase in delinquencies, there is reason to believe that creditors did not underwrite to a rate and payment that would take into account the risk to consumers of a payment shock. Creditors also may not have factored in the consumer's obligation for the expected property taxes and insurance, or the increasingly common ''piggyback'' second-lien loan or line of credit a consumer would use to finance part or all of the down payment.

By frequently basing lending decisions on overstated incomes and understated obligations, creditors were in effect often extending credit based on the value of the collateral, that is, the consumer's house. Moreover, by coupling these practices with a practice of extending credit to borrowers with very limited equity, creditors were often extending credit based on an expectation that the house's value would appreciate rapidly.[56] Creditors may have felt that rapid house price appreciation justified loosening their lending standards, but in some locations house price appreciation was fed by loosened standards, which permitted consumers to take out larger loans and bid up house prices. Loosened lending standards therefore made it more likely that the inevitable readjustment of house prices in these locations would be severe.

House price appreciation began to slow in 2006 and house price levels actually began to decline in many places in 2007. Borrowers who could not afford their mortgage obligations because their repayment ability had not been assessed properly found it more difficult to lower their payments by refinancing. They lacked sufficient equity to meet newly tightened lending standards, or they had negative equity, that is, they owed more than their house was worth. For the same reasons, many consumers also could not extinguish their mortgage obligations by selling their homes. Declining house prices led to sharp increases in serious delinquency rates in both the subprime and alt-A market segments, as discussed above.[57]

Although the focus of § 226.35 is the subprime market, it may cover part of the alt-A market. Disregard for repayment ability was often found in the alt-A market as well. 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. According to one estimate, loans with nontraditional terms that permitted borrowers to defer principal (''interest-only'') or both principal and some interest (''option ARM'') in exchange for higher payments later—reached 78 percent of alt-A originations in 2006.[58] The combination of a variable rate with a deferral of principal and interest held the potential for substantial payment shock within five years. Yet rising delinquency rates to almost 8 percent in 2008, from less than 1 percent in 2006, could suggest that lenders too often assessed repayment ability at a low interest rate and payment that did not adequately account for near-certain payment increases. In addition, these loans typically were made based on reduced income documentation. For example, the share of interest-only mortgages with low or no documentation in alt-A securitized pools increased from around 64 percent in 2003 to nearly 80 percent in 2006.[59] It is generally accepted that the reduced documentation of income led to a high degree of income inflation in the alt-A market just as it did in the subprime market.

Substantial injury. A borrower who cannot afford to make the loan payments as well as payments for property taxes and homeowners insurance because the lender did not adequately assess the borrower's repayment ability suffers substantial injury. Missing mortgage payments is costly: Large late fees are charged and the borrower's credit record is impaired, reducing her credit options. If refinancing to a loan with a lower payment is an option (for example, if the borrower can obtain a loan with a longer maturity), refinancing can slow the rate at which the consumer is able to pay down principal and build equity. The borrower may have to tap home equity to cover the refinancing's closing costs or may have to accept a higher interest rate in exchange for the lender paying the closing costs. If refinancing is not an option, then the borrower and household must make sacrifices to keep the home such as reducing other expenditures or taking additional jobs. If keeping the home is not tenable, the borrower must sell it or endure foreclosure, the costs of which (for example, property maintenance costs, attorneys fees, and other fees passed on to the consumer) will erode any equity

[52] *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* (November 13, 2007) *(Fitch 2006 Subprime Performance)* (reporting that stated income loans with high combined loan to value ratios appear to have become vehicles for fraud).

[53] Consumers may also have been led 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. Consumers who are unaware of this premium are effectively deprived of an opportunity to shop for a potentially lower-rate loan requiring full documentation.

[54] Determined from First American LoanPerformance data. *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).

[55] Figure calculated from First American LoanPerformance data.

[56] Often the lender extended credit knowing that the borrower would have no equity after taking into account a simultaneous second-lien (''piggyback'') loan. According to *Fitch 2006 Subprime Performance,* first-lien loans in subprime securitized pools with simultaneous second liens rose from 1.1 percent in 2000 to 6.4 percent in 2003 to 30 percent in 2006. Moreover, in some cases the appraisal the lender relied on overstated borrower equity because the lender or broker pressured the appraiser to inflate the house value. The prohibition against coercing appraisers is discussed below in part X.B.

[57] Estimates are based on data from *MBA Nat'l Delinquency Survey.*

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

[59] Figures calculated from First American LoanPerformance data.

the consumer had. The foreclosure will mar the consumer's credit record and make it very difficult for the consumer to become a homeowner again any time soon. Many borrowers end up owing the lender more than the house is worth, especially if their homes are sold into a declining market as is happening today in many parts of the country. Foreclosures also may force consumers to move, which is costly and disruptive. In addition to the financial costs of unsustainable lending practices, borrowers and households can suffer serious emotional hardship.

If foreclosures due to irresponsible lending rise rapidly or reach high levels in a particular geographic area, then the injuries can extend beyond the individual borrower and household to the larger community. A foreclosure cluster in a neighborhood can reduce homeowner equity throughout the neighborhood by bringing down prices, eroding the asset that for many households is their largest.[60] A significant rise in foreclosures can create a cycle where foreclosures bring down property values, reducing the ability and incentive of homeowners, particularly those under stress for other reasons, to retain their homes. Foreclosure clusters also can lower municipal tax revenues, reducing a locality's ability to maintain services and make capital investments. At the same time, revenues may be diverted to mitigating hazards that clusters of vacant homes can create.[61]

Lending without regard to repayment ability also has other consequences. It facilitates an abusive strategy of ''flipping'' borrowers in a succession of refinancings designed ostensibly to lower borrowers' burdensome payments that actually convert borrowers' equity into fees for originators without providing borrowers a benefit. Moreover, relaxed standards, such as those that pervaded the subprime market recently, 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. The rapid influx of new originators that can accompany a relaxation of lending standards makes it more difficult for regulators and investors alike to distinguish responsible from irresponsible actors. *See* supra part II.

Injury not reasonably avoidable. One might assume that borrowers could avoid unsustainable loans by comparing their current and expected incomes to their current and expected expenses, including the scheduled loan payments disclosed under TILA and an estimate of property taxes and homeowners insurance. There are several reasons, however, why consumers, especially in the subprime market, accept risky loans they will struggle or fail to repay. In some cases, originators mislead borrowers into entering into unaffordable loans by understating the payment before closing and disclosing the true payment only at closing (''bait and switch''). At the closing table, many borrowers may not notice the disclosure of the payment amount or have time to consider it because borrowers are typically provided with many documents to sign then. Borrowers who consider the disclosure may nonetheless feel constrained to close the loan, for a number of reasons. They may already have paid substantial fees and expect that more applications would require more fees. They may have signed agreements to purchase a new house and sell the current house. Or they 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.

Furthermore, many consumers in the subprime market will accept loans knowing they may have difficulty affording the payments because they reasonably believe a more affordable loan will not be available to them. As explained in part II.B, limited transparency of prices, products, and originator incentives reduces a borrower's expected benefit from shopping further for a better option. Moreover, taking more time to shop can be costly, especially for the borrower in a financial pinch. Thus, borrowers often make a reasoned decision to accept unfavorable terms.

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.B. And borrowers would not realize that a lender was applying loose underwriting standards such as assessing repayment ability on the basis of a ''teaser'' payment. In addition, originators 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.

Stated income and stated asset loans can make it even more difficult for a consumer to avoid an unsustainable loan. With stated income (or stated asset) loans, the applicant may not realize that the originator is inflating the applicant's income and assets to qualify the applicant for the loan. Applicants do not necessarily even know that they are being considered for stated income or stated asset loans. They may give the originator documents verifying their income and assets that the originator keeps out of the loan file because the documents do not demonstrate the income and assets needed to make the loan. Moreover, if a consumer knowingly applies for a stated income or stated asset loan and correctly states her income or assets, the originator can write an inflated figure into the application form. It is typical for the originator to fill out the application for the consumer, and the consumer may not see the written application until closing, when the borrower often is provided with numerous documents to review and sign and may not review the application form with care. The consumer who detects the inflated numbers 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.

Some consumers may also overstate their income or assets with the encouragement of a loan originator who makes it clear that the consumer's actual income or 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.

For all of these reasons, borrowers cannot reasonably avoid injuries from lenders' disregard of repayment ability.

[60] *E.g.,* Zhenguo Lin, et al. *Spillover Effects of Foreclosures on Neighborhood Property Values,* Journal of Real Estate Finance and Economics Online (Nov. 2007), available at *http://www.springerlink.com/content/rk4q0p4475vr3473/fulltext.pdf.*

[61] *E.g.,* William C. Apgar and Mark Duda. *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom* (Minneapolis: Homeownership Preservation Foundation 2005).

Moreover, other consumers who are not parties to irresponsible transactions but suffer from their spillover effects have no ability to prevent these injuries.

Injury not outweighed by countervailing benefits to consumers or to competition. There is no benefit to consumers or competition from loans that are extended without regard to consumers' ability to make even the initial payments. There may be some benefit to consumers from loans that are underwritten based on the collateral and without regard to consumers' ability to sustain their payments past some initial period. For example, a consumer who has lost her principal source of income may benefit from being able to risk her home and her equity in the hope that, before she exhausts her savings, she will obtain a new job that will generate sufficient income to support the payment obligation. The Board believes, however, that this rare benefit is outweighed by the substantial costs to most borrowers and communities of extending higher-risk loans without regard to repayment ability. (Adopting exceptions to the rule for hardship cases would create significant potential loopholes and make the rule unduly complex. The final rule does, however, contain an exemption for temporary or ''bridge'' loans of 12 months or less, though this exemption is intended to be construed narrowly.)

The Board recognizes as well that stated income (or stated asset) lending has at least three potential benefits for consumers and competition. It may speed credit access for consumers who need credit on an emergency basis, save some consumers from expending significant effort to document their income, and provide access to credit for consumers who cannot document their incomes. The first two benefits are limited relative to the substantial injuries caused by lenders' relying on unverified incomes. The third benefit is also limited given that consumers who file proper tax returns can use at least these documents, if no others are available, to verify their incomes. Among higher-priced mortgage loans, where risks to consumers are already elevated, the potential benefits to consumers of stated income/stated asset lending are outweighed by the potential injuries to consumers and competition.

Final Rule

HOEPA and § 226.34(a)(4) currently prohibit a lender from engaging in a pattern or practice of extending HOEPA loans 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. Section 226.34(a)(4) currently provides that a creditor is presumed to have violated this prohibition if it engages in a pattern or practice of failing to verify repayment ability.

The Board proposed to extend this prohibition to higher-priced mortgage loans, *see* proposed § 226.35(b)(1), and to add several additional rebuttable presumptions of violation as well as a safe harbor. Under the proposal a creditor would have been presumed to violate the regulation if it engaged 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)). The proposed safe harbor appeared in § 226.34(a)(4)(ii), which provided 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) and any other factors relevant to determining repayment ability.

The final rule removes the ''pattern or practice'' qualification and therefore prohibits a creditor from extending any HOEPA loan or higher-priced mortgage loan based on the collateral without regard to repayment ability. Like the proposal, the final rule provides that repayment ability is determined according to current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations such as expected property tax and insurance obligations. *See* § 226.34(a)(4) and (a)(4)(i); § 226.35(b)(1). The final rule also shifts the proposed new presumptions of violations to a presumption of compliance, with modifications. The presumption of compliance is revised to specify a finite set of underwriting procedures; the reference to ''any other factors relevant to determining repayment ability'' has been removed. *See* § 226.34(a)(4)(iii). The presumption of violation for failing to verify repayment ability currently in § 226.34(a)(4)(i), however, is being finalized instead as an explicit requirement to verify repayment ability. *See* § 226.34(a)(4)(ii). This section discusses the basic prohibition, and ensuing sections discuss the removal of pattern or practice, the verification requirement, and the presumption of compliance.

As discussed above, the Board finds extending higher-priced mortgage loans or HOEPA loans based on the collateral without regard to the consumer's repayment ability to be an unfair practice. The final rule prohibits this practice. The Board also took into account state laws that declare extending loans to consumers who cannot repay an unfair practice.[62]

Section 226.34(a)(4) governs the process for extending credit; it is not intended to dictate which types of credit or credit terms are permissible and which are not. The rule does not prohibit potentially riskier types of loans such as loans with balloon payments, loans with interest-only payments, or ARMs with discounted initial rates. With proper underwriting, such products may be appropriate for certain borrowers in the subprime market. The regulation merely prohibits a creditor from extending such products or any other higher-priced mortgage loans without adequately evaluating repayment ability.

The rule is intended to ensure that creditors do not assess repayment ability using overstated incomes or understated payment obligations. The rule explicitly requires that the creditor verify income and assets using reliable third party documents and, therefore, prohibits relying merely on an income statement from the applicant. *See* § 226.34(a)(4)(ii). (This requirement is discussed in more detail below.) In addition, the rule requires assessing not just the consumer's ability to pay loan principal and interest, but also the consumer's ability to pay property taxes, homeowners insurance, and similar mortgage-related expenses. Mortgage-related expenses, such as homeowner's association dues or condominium or cooperative fees, are included because failure to pay them could result in a consumer's default on his or her mortgage (if, for example, failure to pay resulted in a senior lien on the unit that constituted a default under the terms of the consumer's mortgage obligations). *See* §§ 226.34(a)(4); 226.34(a)(4)(i).

As of consummation. The final rule provides, as did the proposed rule, that the creditor is responsible for assessing repayment ability as of consummation. Two industry trade associations expressed concern over proposed

[62] *See, e.g.,* Ind. Code §§ 24–4.5–6–102, 24–4.5–6–111(l)(3); Mass. Gen. Laws ch. 93A, ch. 183 §§ 4, 18(a); W.V. Code § 46A–7–109(3)(a).

comment 34(a)(4)-2, indicating that, while a creditor would be liable only for what it knew or should have known as of consummation, events after consummation may be relevant to determining compliance. These commenters contend that creditors should not be held responsible for accurately predicting future events such as a borrower's employment stability or house price appreciation. One asserted that the rule would lead creditors to impose more stringent underwriting criteria in geographic areas with economies projected to decline. These commenters requested that the Board clarify in the commentary that post-closing events cannot be used to second-guess a lender's underwriting decision, and one requested that the commentary specifically state that a foreclosure does not create a presumption of a violation.

The Board has revised the comment, renumbered as 34(a)(4)-5, to delete the statement that 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. Post-consummation events such as a sharp increase in defaults could be relevant to showing a ''pattern or practice'' of disregarding repayment ability, but the final rule does not require proof of a pattern or practice. The final comment retains the proposed statement that a violation is not established if borrowers default because of significant expenses or income losses that occur after consummation. The Board believes it is clear from the regulation and comment that a default does not create a presumption of a violation.

Income, assets, and employment. The final rule, like the proposal, provides that sources of repayment ability include current and reasonably expected income, employment, and assets other than the collateral. For the sake of clarity, new comment 34(a)(4)-2 indicates that a creditor may base its determination of repayment ability on current or reasonably expected income, on assets other than the collateral, or both. A creditor that purported to determine repayment ability on the basis of information other than income or assets would have to clearly demonstrate that this information is probative of repayment ability.

The Board is not adopting the suggestion from several commenters to permit creditors to consider, when determining repayment ability, other characteristics of the borrower or the transaction such as credit score and loan-to-value ratio. These other characteristics may be critical to responsible mortgage underwriting, but they are not as probative as income and assets of the consumer's ability to make the scheduled payments on a mortgage obligation. For example, if a consumer has income of $3,000 per month, it is very unlikely that the consumer will be able to afford a monthly mortgage payment of $2,500 per month regardless of the consumer's credit score or loan-to-value ratio. Moreover, incorporating these other characteristics in the regulation would potentially create a major loophole for originators to discount the importance of income and assets to repayment ability. For the same reasons, the Board also is not adopting the suggestion of some commenters to permit a creditor to rely on any factor that the creditor finds relevant to determine credit or delinquency risk.

The final rule, like the proposal, provides broad flexibility as to the types of income, assets, and employment a creditor may rely on. Specific references to seasonal and irregular employment were added to comment 34(a)(4)–6 (numbered 34(a)(4)–3 in the proposal) in response to requests from commenters. References to several different types of income, such as interest and dividends, were also added. These examples are merely illustrative, not exhaustive.

The final rule and commentary also follow the proposal in permitting a lender to rely on expected income and employment, not just current income and employment. Expectations for improvements in employment or income must be reasonable and verified with third party documents. The commentary gives examples of expected bonuses verified with documents demonstrating past bonuses, and expected employment verified with a commitment letter from the future employer stating a specified salary. *See* comment 34(a)(4)(ii)–3. In some cases a loan may have a likely payment increase that would not be affordable at the borrower's income as of consummation. A creditor may be able to verify a reasonable expectation of an increase in the borrower's income that will make the higher payment affordable to the borrower.

Several commenters expressed concern over language in proposed comment 34(a)(4)–3 indicating that creditors are required, not merely allowed, to consider information about expected changes in income or employment that would undermine repayment ability. The proposed comment gave as an example that a creditor must consider information indicating that an employed person will become unemployed. Some commenters contended that it is appropriate to permit lenders to consider expected income or employment, but inappropriate to require that they do so. Creditors are concerned that they would be liable for accurately assessing a borrower's employment stability, which may depend on regional economic factors.

The final comment, renumbered as 34(a)(4)–5, is revised somewhat to address this concern. The revised comment indicates that a creditor might have knowledge of a likely reduction in income or employment and provides the following example: a consumer's written application indicates that the consumer plans to retire within twelve months or transition from full-time to part-time employment. As the example indicates, the Board does not intend to place unrealistic requirements on a creditor to speculate or inquire about every possible change in a borrower's life circumstances. The sentence ''a creditor may have information indicating that an employed person will become unemployed'' is deleted as duplicative.

Finally, new comment 34(a)(4)–7 addresses the concern of several commenters that the proposal appeared to require them to make inquiries of borrowers or consider information about them that Regulation B, 12 CFR part 202, would prohibit, such as a question posed solely to a female applicant as to whether she is likely to continue her employment. The comment explains that § 226.34(a)(4) does not require or permit the creditor to make inquiries or verifications that would be prohibited by Regulation B.

Obligations. The final rule, like the proposed rule, requires the creditor to consider the consumer's current obligations as well as mortgage-related obligations such as expected property tax and required insurance. *See* § 226.34(a)(4)(i). The final rule does not contain the proposed rule's reference to ''expected obligations.'' An industry trade association suggested the reference would stifle communications between a lender and a consumer because the lender would seek to avoid eliciting information about the borrower's plans for future indebtedness, such as an intention to take out student loans to send children to college. The Board agrees that the proposal could stifle communications. This risk does not have a sufficient offsetting benefit because it is by nature speculative whether a mortgage borrower will undertake other credit obligations in the future.

A reference to simultaneous mortgage obligations (proposed comment 34(a)(4)(i)–2)) has been retained but revised. *See* comment 34(a)(4)–3. Several commenters objected to the proposed comment. They suggested a lender has a limited ability to identify the existence of a simultaneous obligation with an unaffiliated lender if the borrower does not self-report. They asked that the requirement be restricted to simultaneous obligations with the same lender, or that it be limited to obligations the creditor knows or has reason to know about, or that it have a safe harbor for a lender that has procedures to prevent consumers from obtaining a loan from another creditor without the lender's knowledge. The comment has been revised to indicate that the regulation makes a creditor responsible for considering only those simultaneous obligations of which the creditor has knowledge.

Exemptions. The Board is adopting the proposed exemptions from the rule for bridge loans, construction-only loans, reverse mortgages, and HELOCs. These exemptions are discussed in part VIII.H. A national bank and two trade associations with national bank members requested an additional exemption for national banks that are in compliance with OCC regulation 12 CFR 34.3(b). The OCC regulation prohibits national banks from making a mortgage loan based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral without regard to the borrower's ability to repay the loan according to its terms. Unlike HOEPA, however, the OCC regulation does not authorize private actions or actions by state attorneys general when the regulation is violated. Thus, the Board is not adopting the requested exemption.

Pattern or Practice

Based on the comments and additional information gathered by the Board, the Board is adopting the rule without the phrase ''pattern or practice.'' The rule therefore prohibits an individual HOEPA loan or higher-priced mortgage loan from being extended based on the collateral without regard to repayment ability. TILA Section 129(l)(2), 15 U.S.C. 1638(l)(2), confers on the Board authority to revise HOEPA's restrictions on HOEPA loans if the Board finds that such revisions are necessary to prevent unfair or deceptive acts or practices in connection with mortgage loans. The Board so finds for the reasons discussed below.

Public comment. Consumer advocates and others strongly urged the Board to remove the pattern or practice element. They argued that the burden to prove a pattern or practice is so onerous as to make it impracticable for an individual plaintiff to seek relief, either affirmatively or in recoupment. They suggested a typical plaintiff does not have the resources to obtain information about a lender's loans and loan policies sufficient to allege a pattern or practice. Moreover, should a plaintiff be able to allege a pattern or practice and proceed to the discovery stage, one legal aid organization commented based on direct experience that a creditor may produce a mountain of documents that overwhelms the plaintiff's resources and makes it impractical to pursue such cases. One consumer group argued that the proposed rule would not adequately deter abuse because, by the time a pattern or practice emerged, substantial harm would already have been done to consumers and investors. This commenter also argued that other TILA provisions give creditors sufficient protection against litigation risk, such as the cap on class action damages, the right to cure certain errors creditors discover on their own, and the defense for *bona fide* errors.

Several lenders and lender trade associations expressed concern that ''pattern or practice'' is too vague to provide the certainty creditors seek and asked for more specific guidance and examples. Other industry commenters contended that the phrase was likely to be interpreted to hold lenders that originate large numbers of loans liable for errors in assessing repayment ability in just a small fraction of their originations. For example, one large lender pointed out that an error rate of 0.5 percent in its 400,000 HMDA-reportable originations in 2006 would have amounted to 2,000 loans. Several commenters cited cases decided under other statutes holding that a mere handful of instances were a pattern or practice. To address these concerns, two commenters requested that the phrase be changed to ''systematic practice'' and that this new phrase be interpreted to mean willful or reckless disregard. Industry commenters generally preferred that ''pattern or practice,'' whatever its limitations, be retained as a form of protection against unwarranted litigation.

Discussion. The Board believes that removing ''pattern or practice'' is necessary to ensure a remedy for consumers who are given unaffordable loans and to deter irresponsible lending, which injures not just individual borrowers but also their neighbors and communities. The Board further believes that the presumption of compliance the Board is adopting will provide more certainty to creditors than either ''pattern or practice'' or the proposed safe harbor. The presumption will better aid creditors with compliance planning, and it will better help them mitigate litigation risk. In short, the Board believes that removing ''pattern or practice'' and providing creditors a presumption of compliance will be more effective to prevent unfair practices, remedy them when they occur, and preserve access to credit.

Imposing the burden to prove ''pattern or practice'' on an individual borrower would leave many borrowers without a remedy under HOEPA for loans that were made without regard to repayment ability. Borrowers would not have a HOEPA remedy for individual, unrelated loans made without regard to repayment ability, of which there could be many in the aggregate. Even if an unaffordable loan was part of a pattern or practice, the individual borrower and his or her attorney would not necessarily have that information.[63] By the time information about a particular lender's pattern or practice of unaffordable lending became widespread, the lender could have caused great injury to many borrowers, as well as to their neighbors and communities. In addition, imposing a ''pattern or practice'' requirement on HOEPA loans, but not higher-priced mortgage loans, would create an anomaly.

Moreover, a ''pattern or practice'' claim can be costly to litigate and might not be economically feasible except as part of a class action, which would not assure individual borrowers of adequate remedies. Class actions can take years to reach a settlement or trial, while the individual borrower who is facing foreclosure because of an unaffordable loan requires a speedy resolution if the borrower is to keep the home. Moreover, lower-income homeowners are often represented by legal aid organizations, which are barred from bringing class actions if they accept funds from the Legal Services Corporation.[64]

To be sure, many borrowers who would be left without a HOEPA remedy for an unaffordable loan may have remedies under state laws that lack a ''pattern or practice'' requirement. In some cases, however, state law remedies would be inferior or unavailable. Moreover, state laws do not assure consumers uniform protection because these laws vary considerably and

[63] Federal rules of civil procedure require that a defendant's motion to dismiss be granted unless the plaintiff alleged sufficient facts to make a pattern or practice ''plausible.'' *Bell Atlantic* v. *Twombly,* 127 S. Ct. 1955 (2007). Many states follow the federal rules.

[64] 45 CFR 1617.3.

generally may not cover federally chartered depository institutions (due to federal preemption) or state chartered depository institutions (due to specific exemptions or general ''parity laws'').

For these reasons, imposing the burden to prove ''pattern or practice'' on an individual borrower would leave many borrowers with a lesser remedy, or without any remedy, for loans made without regard to repayment ability. Removing this burden would not only improve remedies for individual borrowers, it would also increase deterrence of irresponsible lending. Individual remedies impose a more immediate and more certain cost on violators than either class actions or actions by state or federal agencies, which can take years and, in the case of the agencies, are subject to resource constraints. Increased deterrence of irresponsible lending practices should benefit not just borrowers who might obtain higher-priced mortgage loans but also their neighbors and communities who would otherwise suffer the spillover effects of such practices.

The Board acknowledges the legitimate concerns that lenders have expressed over litigation costs. As the Board indicated with the proposal, it proposed ''pattern or practice'' out of a concern that 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. After further study, however, the Board believes that any increase in litigation risk would be justified by the substantial benefits of a rule that provided remedies to individual borrowers. While unwarranted litigation may well increase, the Board believes that several factors will mitigate this cost. In particular, TILA imposes a one-year statute of limitations on affirmative claims, after which only recoupment and set-off are available; HOEPA limits the strict assignee liability of TILA Section 131(d), 15 U.S.C. 1641(d) to HOEPA loans; many defaults may be caused by intervening events such as job loss rather than faulty underwriting; and plaintiffs (or their counsel) may bear a substantial cost to prove a claim of faulty underwriting, which would often require substantial discovery and expert witnesses. Creditors could further contain litigation risk by using the procedures specified in the regulation that earn the creditor a presumption of compliance.

The Board has also considered the possibility that the statute's ''pattern or practice'' element allows creditors an appropriate degree of flexibility to extend occasional collateral-based HOEPA loans to consumers who truly need them and clearly understand the risks involved. Removing ''pattern or practice'' would eliminate this potential consumer benefit. Based on industry comments, however, the benefit is more theoretical than real. While industry commenters may prefer retaining ''pattern or practice'' as a barrier to individual suits, these commenters indicated that ''pattern or practice'' is too vague to be useful for compliance planning. Therefore, retaining ''pattern or practice'' would not likely lead a creditor to extend legitimate collateral-based loans except, perhaps, a trivial number such as one per year.

The Board reached this conclusion only after exploring ways to provide more clarity as to the meaning of ''pattern or practice.'' Existing comment 34(a)(4)–2 provides that a pattern or practice depends on the totality of the circumstances in the particular case; can be established without the use of a statistical process and on the basis of an unwritten lending policy; and cannot be established with isolated, random, or accidental acts. Although this comment has been in effect for several years, its effectiveness is impossible to assess because the market for HOEPA loans shrank to near insignificance soon after the comment was adopted.[65] On its face, however, the guidance removes little of the uncertainty surrounding the meaning of ''pattern or practice.'' (There is only one reported decision to interpret ''pattern or practice'' under HOEPA, *Newton* v. *United Companies Financial Corp.,* 24 F. Supp. 2d 444 (E.D. Pa. 1998), and it has limited precedential value in light of later-adopted comment 34(a)(4)–2.) The Board re-proposed the comment but commenters provided few concrete suggestions for making the rule clearer and the suggestions that were offered would have left a large degree of uncertainty.

The Board considered other potential sources of guidance on ''pattern or practice'' from other statutes and regulations. Case law is of inherently limited value for such a contextual inquiry. Moreover, there are published court decisions, some cited by industry commenters, that suggest that even a few instances could be considered to meet this standard.[66] The Board also consulted informal guidance interpreting ''pattern or practice'' under ECOA.[67] The Board carefully considered how it could adapt this guidance to § 226.34(a)(4). Based on its efforts, the Board concluded that, while additional guidance could reduce some uncertainty, it would necessarily leave substantial uncertainty. The Board further concluded that significantly more certainty could be provided through the ''presumption of compliance'' the final rule provides for following enumerated underwriting practices. *See* § 226.34(a)(4)(iii), discussed below.

Verification of Repayment Ability

Section 226.34(a)(4) currently contains a provision creating a rebuttable presumption of a violation where a lender engages in a pattern or practice of making HOEPA loans without verifying and documenting repayment ability. The Board proposed to retain this presumption and extend it to higher-priced mortgage loans. The final rule is different in two respects. First, as discussed above, the final rule does not contain a ''pattern or practice'' element. Second, it makes verifying repayment ability an affirmative requirement, rather than making failure to verify a presumption of a violation.

In the final rule, the regulation applies the verification requirement to current obligations explicitly, *see* § 226.34(a)(4)(ii)(C); in the proposal, an explicit reference to obligations was in a staff comment. *See* proposed comment 34(a)(4)(i)(A)–2, 73 FR at 1732. The requirement to verify income and assets in final § 226.34(a)(4)(ii)(A) is essentially identical to the requirement of proposed § 226.35(b)(2). Under § 226.34(a)(4)(ii)(A), creditors must verify assets or income, including expected income, relied on in approving an extension of credit using third-party documents that provide reasonably reliable evidence of the income or assets. The final rule, like that proposed, includes an affirmative defense for a creditor that can show that the amounts of the consumer's income or assets relied on were not materially greater than the amount the creditor could have verified at consummation.

Public comment. Many, but by no means all, financial institutions, mortgage brokers, and mortgage industry trade groups that commented support a verification requirement. They raised concerns, however, that the particular requirement proposed would

[65] By 2004, HOEPA loans reported under HMDA were less than one percent of the mortgage market. The Board does not believe the market's contraction can be traced to the guidance on pattern or practice.

[66] *See, e.g., United States* v. *Balistrieri*, 981 F.2d 916, 929–30 (7th Cir. 1992); *United States* v. *Pelzer Realty Co., Inc.*, 484 F.2d 438, 445 (5th Cir. 1973).

[67] Board Policy Statement on Enforcement of the Equal Credit Opportunity and Fair Housing Acts, Q9.

restrict or eliminate access to credit for some borrowers, especially the self-employed, those who earn irregular commission- or cash-based incomes, and low- and moderate-income borrowers. Consumer and community groups and government officials generally supported the proposed verification requirement, with some suggesting somewhat stricter requirements. Many of these same commenters, however, contended the proposed affirmative defense would be a major loophole and urged its elimination. The comments are discussed in further detail below as applicable.

Discussion. For the reasons discussed above, the Board finds that it is unfair not to verify income, assets, and obligations used to determine repayment ability when extending a higher-priced mortgage loan or HOEPA loan. The Board is finalizing the rule as proposed and incorporating it directly into § 226.34(a)(4), where it replaces the proposed presumption of a violation for a creditor that has a pattern or practice of failing to verify repayment ability. ''Pattern or practice'' has been removed and the presumption has been made a requirement. The legal effect of this change is that the final rule, unlike the proposal, would rarely, if ever, permit a creditor to make even isolated ''no income, no asset'' loans (loans made without regard to income and assets) in the higher-priced mortgage loan market. For the reasons explained above, however, the Board does not believe this legal change will reduce credit availability; nor will it affect the availability of ''no income, no asset'' loans in the prime market.

As discussed above, relying on inflated incomes or assets to determine repayment ability often amounts to disregarding repayment ability, which causes consumers injuries they often cannot reasonably avoid. By requiring verification of income and assets, the final rule is intended to limit these injuries by reducing the risk that higher-priced mortgage loans will be made on the basis of inflated incomes or assets.[68] The Board believes the rule is sufficiently flexible to keep costs to consumers, such as any additional time needed to close a loan or costs for obtaining documentation, at reasonable levels relative to the expected benefits of the rule.

The rule specifically authorizes a creditor to rely on W–2 forms, tax returns, payroll receipts, and financial institution records such as bank statements. These kinds of documents are sufficiently reliable sources of information about borrowers' income and assets that the Board believes it is appropriate to provide a safe harbor for their use. Moreover, most consumers can, or should be able to, produce one of these kinds of documents with little difficulty. For other consumers, the rule is quite flexible. It permits a creditor to rely on any third-party document that provides reasonably reliable evidence of the income or assets relied on to determine repayment ability. Examples include check-cashing or remittance receipts or a written statement from the consumer's employer. *See* comment 34(a)(4)(ii)(A)–3. These examples are only illustrative, not limiting. The one type of document that is excluded is a statement only from the consumer.

Many commenters suggested that the Board require creditors to collect the ''best and most appropriate'' documentation. The Board believes that the costs of such a requirement would outweigh the benefits. The vagueness of the suggested standard could make creditors reluctant to accept nontraditional forms of documentation. Nor is it clear how creditors would verify that a form of documentation that might be best or most appropriate was not available.

The commentary has been revised to clarify several points. *See* comments 34(A)(4)(ii)(A)–3 and –4. Oral information from a third party would not satisfy the rule, which requires documentation. Creditors may, however, rely on a letter or an e-mail from the third party. Creditors may also rely on third party documentation the consumer provides directly to the creditor. Furthermore, as interpreted by the comments, the rule excludes documents that are not specific to the consumer. It would not be sufficient to look at average incomes for the consumer's stated profession in the region where the consumer lives or average salaries for employees of the consumer's employer. The commentary has been revised, however, to indicate that creditors may use third party information that aggregates individual-specific data about consumers' income, such as a database service used by an employer to centralize income verification requests, so long as the information is reasonably current and accurate and identifies the specific consumer's income.

The rule does not require creditors that have extended credit to a consumer and wish to extend new credit to the same consumer to re-collect documents that the creditor previously collected from the consumer, if the creditor believes the documents would not have changed since they were initially verified. *See* comment 34(a)(4)(ii)(A)–5. For example, if the creditor has collected the consumer's 2006 tax return for a May 2007 loan, and the creditor makes another loan to that consumer in August 2007, the creditor may rely on the 2006 tax return.

Nor does the rule require a creditor to verify amounts of income or assets the creditor is not relying on to determine repayment ability. For example, if a creditor does not rely on a part of the consumer's income, such as an annual bonus, in determining repayment ability, the creditor would not need to verify the consumer's bonus. A creditor may verify an amount of income or assets less than that stated in the loan file if adequate to determine repayment ability. If a creditor does not verify sufficient amounts to support a determination that the consumer has the ability to pay the loan, however, then the creditor risks violating the regulation.

Self-employed borrowers. The Board has sought to address commenters' concerns about self-employed borrowers. The rule allows for flexibility in underwriting standards so that creditors may adapt their underwriting processes to the needs of self-employed borrowers, so long as creditors comply with § 226.34(a)(4). For example, the rule does not dictate how many years of tax returns or other information a creditor must review to determine a self-employed applicant's repayment ability. Nor does the rule dictate which income figure on the tax returns the creditor must use. The Internal Revenue Code may require or permit deductions from gross income, such as a deduction for capital depreciation, that a creditor reasonably would regard as not relevant to repayment ability.

The rule is also flexible as to consumers who depend heavily on bonuses and commissions. If an employed applicant stated that he was likely to receive an annual bonus of a certain amount from the employer, the creditor could verify the statement with third-party documents showing a consumer's past annual bonuses. *See* comment 34(a)(4)(ii)–1. Similarly, employees who work on commission could be asked to produce third-party documents showing past commissions.

The Board is not adopting the exemption some commenters requested for self-employed borrowers. The exemption would give borrowers and originators an incentive to declare a borrower employed by a third party to

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

be self-employed to avoid having to verify the borrower's income. It is not clear how a declaration of self-employed status could be verified except by imposing the very burden the exemption would be meant to avoid, such as reviewing tax returns.

The affirmative defense. The Board received a number of comments about the proposed affirmative defense for a creditor that can show that the amounts of the consumer's income or assets the creditor relied on were not materially greater than what the creditor could have documented at consummation. The Board's reference to this defense as a ''safe harbor'' appears to have caused some confusion. Many commenters interpreted the phrase ''safe harbor'' to mean that the Board was proposing a specific way to comply with the rule. These commenters either criticized the safe harbor as insufficiently specific about how to comply (in the case of industry commenters) or urged that it be eliminated as a major loophole for avoiding verifying income and assets (in the case of consumer group and other commenters).

The Board intended the provision merely as a defense for a lender that did not verify income as required where the failure did not cause injury. The provision would place the burden on the lender to prove that its non-compliance was immaterial. A creditor that does not verify income has no assurance that the defense will be available should the loan be challenged in court. This creditor takes a substantial risk that it will not be able to prove through discovery that the income was as stated. Therefore, the Board expects that the defense will be used only in limited circumstances. For example, a creditor might be able to use the defense when a *bona fide* compliance error, such as an occasional failure of reasonable procedures for collecting and retaining appropriate documents, produces litigation. The defense is not likely to be helpful to a creditor in the case of compliance examinations because there will not be an opportunity in that context for the creditor to determine the borrower's actual income. With this clarification, the Board is adopting the affirmative defense as proposed.

The defense is available only where the creditor can show that the amounts of income and assets relied on were not materially greater than the amounts the creditor could have verified. The definition of ''material'' is not based on a numerical threshold as some commenters suggested. Rather, the commentary has been revised to clarify that creditors would be required to show that, if they had relied on the amount of verifiable income or assets, their decision to extend credit and the terms of the credit would not have been different. *See* comment 34(a)(4)(ii)(B)–2.

Narrower alternatives. The Board sought comment on whether the rule should be narrowed to prohibit only extending credit where the creditor or mortgage broker engaged in, influenced the borrower to engage in, or knew of income or asset inflation. The vast majority of commenters who addressed this alternative did not support it, and the Board is not adopting it. Placing the burden on the borrower or supervisory agency to prove the creditor knew the income was inflated would undermine the rule's effectiveness. In the case of borrower claims or counter-claims, this burden would lead to costly discovery into factual questions, and this discovery would often produce conflicting evidence (''he said, she said'') that would require trial before a factfinder. A creditor significantly increases the risk of income inflation when it accepts a mere statement of income, and the creditor is in the best position to substantially reduce this risk at limited cost by simply requiring documentation. The Board believes this approach is the most effective and efficient way to protect not just the individual borrower but also the neighbors and communities that can suffer from spillover effects of unaffordable lending.

Some industry commenters suggested adopting an affirmative defense for creditors who can show that the consumer intentionally misrepresented income or assets or committed fraud. The Board is not adopting this defense. As discussed above, a rule that provided creditors with a defense where no documentation was present could result in litigation that was costly for both sides. A defense for cases of consumer misrepresentation or fraud where the creditor documented the consumer's income or assets would be unnecessary. Creditors are allowed to rely on documents provided directly by the consumer so long as those documents provide reasonably reliable evidence of the consumer's income or assets. A consumer who provided false documentation to the creditor, and who wished to bring a claim against the creditor, would have to demonstrate that the creditor reasonably should not have relied on the document. If the only fact that made the document unreliable was the consumer's having provided false information without the creditor's knowledge, it would not have been unreasonable for the creditor to rely on that document.

Obligations. The proposal essentially required a creditor to verify repayment ability; it provided that a pattern or practice of failing to verify repayment ability created a presumption of a violation. A proposed comment indicated that verifying repayment ability included verifying obligations. *See* proposed comment 34(a)(4)(i)(A)–2. The final rule explicitly includes the requirement to verify obligations in the regulation. *See* § 226.34(a)(4)(ii)(C). A comment to this provision indicates that a credit report may be used to verify current obligations. A credit report, however, might not reflect certain obligations undertaken just before or at consummation of the transaction and secured by the same dwelling that secures the transaction (for example, a ''piggyback'' second-lien transaction used to finance part of the down payment on the house where the first-lien transaction is for home purchase). A creditor is responsible for considering such obligations of which the creditor has knowledge. *See* comment 34(a)(4)–3.

Presumption of Compliance

The Board proposed to add new, rebuttable presumptions of violations to § 226.34(a)(4) and, by incorporation, § 226.35(b)(1). These presumptions would have been 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; consumers' ability to make fully-amortizing loan payments that include expected property taxes and homeowners insurance; the ratio of borrowers' total debt obligations to income as of consummation; and borrowers' residual income. *See* proposed § 226.34(a)(4)(i)(B)–(E). The Board also proposed a presumption of compliance for a creditor that 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) and any other factors relevant to determining repayment ability.

The final rule removes the proposed presumptions of violation for failing to follow certain underwriting practices and incorporates these practices, with modifications, into a presumption of compliance that is substantially revised from that proposed. Under § 226.34(a)(4)(iii), a creditor is presumed to have complied with § 226.34(a)(4) if the creditor satisfies each of three requirements: (1) Verifying repayment ability; (2) determining the consumer's repayment ability using largest scheduled payment of principal and interest in the first seven years following consummation and taking into account property tax and insurance obligations and similar mortgage-related expenses; and (3) assessing the consumer's repayment ability using at least one of the following measures: a ratio of total debt obligations to income, or the income the consumer will have after paying debt obligations. (The procedures for verifying repayment ability are required under paragraph 34(a)(4)(ii); the other procedures are not required.)

Unlike the proposed presumption of compliance, the presumption of compliance in the final rule is not conditioned on a requirement that a creditor have a reasonable basis to believe that a consumer will be able to make loan payments for a specified period of years. Comments from creditors indicated this proposed requirement was not necessary and introduced an undue degree of compliance uncertainty. The final presumption of compliance, therefore, replaces this general requirement with the three specific procedural requirements mentioned in the previous paragraph.

The creditor's presumption of compliance for following these procedures is not conclusive. The Board believes a conclusive presumption could seriously undermine consumer protection. A creditor could follow the procedures and still disregard repayment ability in a particular case or potentially in many cases. Therefore, the borrower may rebut the presumption with evidence that the creditor disregarded repayment ability despite following these procedures. For example, evidence of a very high debt-to-income ratio and a very limited residual income could be sufficient to rebut the presumption, depending on all of the facts and circumstances. If a creditor fails to follow one of the non-mandatory procedures set forth in paragraph 34(a)(4)(iii), then the creditor's compliance is determined based on all of the facts and circumstances without there being a presumption of either compliance or violation. *See* comment 34(a)(4)(iii)–1.

Largest scheduled payment in seven years. When a loan has a fixed rate and a fixed payment that fully amortizes the loan over its contractual term to maturity, there is no ambiguity about the rate and payment at which the lender should assess repayment ability: The lender will use the fixed rate and the fixed payment. But when the rate and payment can change, as has often been true of subprime loans, a lender has to choose a rate and payment at which to assess repayment ability. The Board proposed that a creditor would be presumed to have disregarded repayment ability if it had engaged in a pattern or practice of failing to use the fully-indexed rate (or the maximum rate in seven years on a step-rate loan) and the fully-amortizing payment.

As discussed, the final rule does not contain this proposed presumption of violation. Instead, it provides that a creditor will have a presumption of compliance if, among other things, the creditor uses the largest scheduled payment of principal and interest in the first seven years. This payment could be higher, or lower, than the payment determined according to the fully-indexed rate and fully-amortizing payment. The Board believes that the final rule is clearer and simpler than the proposal. It incorporates long-established principles in Regulation Z for determining a payment schedule when rates or payments can change, which should facilitate compliance. *See* comment 34(a)(4)(iii)(B)–1. The final rule is also more flexible than the proposal. Instead of requiring the creditor to use a particular payment, it provides the creditor who uses the largest scheduled payment in seven years a presumption of compliance. The creditor has the flexibility to use a lower payment, and no presumption of violation would attach; though neither would a presumption of compliance. Instead, compliance would be determined based on all of the facts and circumstances.

Two aspects of § 226.34(a)(4) help ensure that this approach provides consumers effective protection. First, the Board is adopting the proposed seven-year horizon. That is, under § 226.34(a)(4)(iii)(B) the relevant payment for underwriting is the largest payment in seven years. Industry commenters requested that the rule incorporate a time horizon of no more than five years. As these commenters indicated, most subprime loans, including those with fixed rates, have paid off (or defaulted) within five years. It is possible that prepayment speeds will slow, however, as subprime lending practices and loan terms undergo substantial changes. Moreover, the final rule addresses commenters' concern that the proposal seemed to require them to project the consumer's income, employment, and other circumstances for as long as seven years as a condition to obtaining a presumption of compliance. Under the final rule, the creditor is expected to underwrite based on the facts and circumstances that exist as of consummation. Section 226.34(a)(4)(iii)(B) sets out the payment to which the creditor should underwrite if it seeks to have a presumption of compliance. Furthermore, nothing in the regulation prohibits, or creates a presumption against, loan products that are designed to serve consumers who legitimately expect to sell or refinance sooner than seven years.

A second aspect of § 226.34(a)(4) that is integral to its balance of consumer protection and credit availability is its exclusion of two nontraditional types of loans from the presumption of compliance that can pose more risk to consumers in the subprime market. Under § 226.34(a)(4)(iv), no presumption of compliance is available for a balloon-payment loan with a term shorter than seven years. If the term is at least seven years, the creditor that underwrites the loan based on the regular payments (not the balloon payment) may retain the presumption of compliance. If the term is less than seven years, compliance is determined on the basis of all of the facts and circumstances. This approach is simpler than some of the alternatives commenters recommended to address balloon-payment loans, and it better balances consumer protection and credit availability than other alternatives they suggested.[69] Consumers are statistically very likely to prepay (or default) within seven years and avoid the balloon payment.

Loans with scheduled payments that would increase the principal balance (negative amortization) within the first seven years are also excluded from the presumption of compliance. This exclusion will help ensure that the presumption is available only for loans that leave the consumer sufficient equity after seven years to refinance. If the payments scheduled for the first seven years would cause the balance to increase, then compliance is determined

[69] One large lender contended that balloon loans should be exempted from a repayment-ability rule because consumers understand their risks. Another recommended that balloon loans be exempted from the repayment ability rule if the term of the loan exceeds seven years for first-lien mortgages or five years for subordinate-lien loans. A trade association representing community banks urged that balloon payments be permitted so long as the creditor has a reasonable basis to believe the borrower will make the payments for the term of the loan except the final, balloon payment. This trade association indicated that community banks often structure the loans they hold in portfolio as 3- or 5-year balloon loans, typically with 15–30 year amortization periods, to match the maturity of the loan to the maturity of their deposit base. A lender and a lender trade association recommended using on short-term balloon loans a payment larger than the scheduled payment but smaller than the fully-amortizing payment, such as the payment that would correspond to an interest rate two percentage points higher than the rate specified in the presumption of compliance.

on all of the facts and circumstances without a presumption of compliance or violation.

''Interest-only'' loans can have a presumption of compliance. With these loans, after an initial period of interest-only payments the payment is recast to fully amortize the loan over the remaining term to maturity. If the period of interest-only payments is shorter than seven years, the creditor may retain the presumption of compliance if it uses the fully-amortizing payment that commences after the interest-only period. If the interest-only period is seven years or longer, the creditor may retain the presumption of compliance if it assesses repayment ability using the interest-only payment. Examples have been added to the commentary to facilitate compliance. *See* comment 34(a)(4)(iii)(B)–1. Examples of variable-rate loans and a step-rate loan have also been added.

Debt-to-income ratio and residual income. The proposal provided that a creditor would be presumed to have violated the regulation if it engaged in a pattern or practice of failing to consider the ratio of consumers' total debt obligations to consumers' income or the income consumers will have after paying debt obligations. A major secondary market participant proposed that considering total DTI and residual income not be an absolute prerequisite because other measures of income, assets, or debts may be valid methods to assess repayment ability. A credit union trade association contended that residual income is not a necessary underwriting factor if a lender uses DTI. Consumer and civil rights groups, however, specifically support including both DTI and residual income as factors, contending that residual income is an essential component of an affordability analysis for lower-income families.

Based on the comments and its own analysis, the Board is revising the proposal to provide that a creditor does not have a presumption of compliance with respect to a particular transaction unless it uses at least one of the following: the consumer's ratio of total debt obligations to income, or the income the consumer will have after paying debt obligations. Thus, the final rule permits a creditor to retain a presumption of compliance so long as it uses at least one of these two measures.

The Board believes the flexibility permitted by the final rule will help promote access to responsible credit without weakening consumer protection. The rule provides creditors flexibility to determine whether using both a DTI ratio and residual income increases a creditor's ability to predict repayment ability. If one of these metrics alone holds as much predictive power as the two together, as may be true of certain underwriting models at certain times, then conditioning access to a safe harbor on using both metrics could reduce access to credit without an offsetting increase in consumer protection. The Board also took into account that, at this time, residual income appears not to be as widely used or tested as the DTI ratio.[70] It is appropriate to permit the market to develop more experience with residual income before considering whether to incorporate it as an independent requirement of a regulatory presumption of compliance.

The final rule does not contain quantitative thresholds for either of the two metrics. The Board specifically solicited comment on whether it should adopt such thresholds. Industry commenters did not favor providing a presumption of compliance (or a presumption of a violation) based on a specified debt-to-income ratio. The reasons given include: Different investors have different guidelines for lenders to follow in calculating DTI; underwriters following the same procedures can calculate different DTIs on the same loan; borrowers may want or, in some high-cost areas, may need to spend more than any specified percentage of their income on housing and may have sufficient non-collateral assets or residual incomes to support the loan; and loans with high DTIs have not necessarily had high delinquency rates. Two trade associations indicated they would accept a quantitative safe harbor if it were sufficiently flexible. Some commenters suggested a standard of reasonableness.

Consumer and civil rights groups, a federal banking agency, and others requested that the Board set threshold levels for both DTI and residual income beyond which a loan would be considered unaffordable, subject to rebuttal by the creditor. They argued that quantitative thresholds for these factors would improve compliance and loan performance. These commenters suggested that the regulation should expressly recognize that, as residual income increases, borrowers can support higher DTI levels. They provided alternative recommendations: mandate the DTI and residual income levels found in the guidelines for loans guaranteed by the Department of Veterans Affairs, 38 CFR 36.4840; develop the Board's own guidelines; or impose a threshold of 50 percent DTI with sufficient residual income. A consumer research and advocacy group, however, supported the Board's proposal not to set a quantitative threshold. It specifically opposed a 50 percent threshold as too high for sustainable lending. It further maintained that any specific DTI threshold would not be workable because proper underwriting depends on too many factors, and the definition of ''debt'' is too easily manipulated.

The Board is concerned that making a specific DTI ratio or residual income level either a presumptive violation or a safe harbor could limit credit availability without providing adequate offsetting benefits. The same debt-to-income ratio can have very different implications for two consumers' repayment ability if the income levels of the consumers differ significantly. Moreover, it is not clear what thresholds would be appropriate. Limited data are available to the Board to support such a determination. Underwriting guidelines of the Department of Veterans Affairs may be appropriate for the limited segment of the mortgage market this agency is authorized to serve, but they are not necessarily appropriate for the large segment of the mortgage market this regulation will cover.

Safe Harbors and Exemptions Not Adopted

Commenters requested several safe harbors or exemptions that the Board is not adopting. Many industry commenters sought a safe harbor for any loan approved by the automated underwriting system (AUS) of Fannie Mae or Freddie Mac; some sought a safe harbor for an AUS of any federally-regulated institution. The Board is not adopting such a safe harbor. Commenters did not suggest a clear and objective definition of an AUS that would distinguish it from other types of systems used in underwriting. It would not be appropriate to try to resolve this concern by limiting a safe harbor to the AUS's of Fannie Mae and Freddie Mac, as that would give them an unfair advantage in the marketplace. Moreover, a safe harbor for an AUS that is a ''black box'' and is not specifically required to comply with the regulation could undermine the regulation. Some industry commenters sought safe harbors for transactions that provide the consumer a lower rate or payment on the grounds that these transactions would generally benefit the borrower.

[70] Michael E. Stone, *What is Housing Affordability? The Case for the Residual Income Approach,* 17 Housing Policy Debate 179 (Fannie Mae 2006) (advocating use of a residual income approach but acknowledging that it ''is neither well known, particularly in this country, nor widely understood, let alone accepted'').

The chief example given is a refinance (without cash out) that reduces the consumer's current monthly payment or, in the case of an ARM, the payment expected upon reset. The Board does not believe that a safe harbor for such a transaction would benefit consumers. For example, it could provide an incentive to an originator to make an unaffordable loan to a consumer and then repeatedly refinance the loan with new loans offering a slightly lower payment each time.

One state Attorney General submitted a comment supporting permitting an asset-based loan where the borrower has suffered a loss of income but reasonably anticipates improving her circumstances (*e.g.*, temporary disability or illness, unemployment, or salary cut), or the borrower seeks a short-term loan because she must sell the home due to a permanent reduction in income (*e.g.*, loss of job, or divorce from co-borrower) or some other event (*e.g.*, pending foreclosure or occurrence of natural disaster). An association of mortgage brokers also recommended that exceptions be made for such cases.

The Board is not adopting safe harbors or exemptions for such ''hardship'' cases. As discussed above, the Board recognizes that consumers in such situations who fully understood the risks involved would benefit from having the ability to address their situation by taking a large risk with their home equity. At the same time, the Board is concerned that exceptions for such cases could severely undermine the rule because it would be difficult, if not impossible, to distinguish *bona fide* cases from mere circumvention. For some of these cases, such as selling a home due to divorce or job loss (or any reason) and purchasing a new, presumably less expensive home, the carve-out for bridge loans may apply.

C. Prepayment Penalties—§ 226.32(d)(6) and (7); § 226.35(b)(2)

The Board proposed to apply to higher-priced mortgage loans the prepayment penalty restrictions that TILA Section 129(c) applies to HOEPA loans. Specifically, HOEPA-covered loans may only have a prepayment penalty if: The penalty period does not exceed five years from loan consummation; the penalty does not apply if there is a refinancing by the same creditor or its affiliate; the borrower's debt-to-income (DTI) ratio at consummation does not exceed 50 percent; 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). In addition, the Board proposed, for both HOEPA loans and higher-priced mortgage loans, to require that the penalty period expire at least sixty days before the first date, if any, on which the periodic payment amount may increase under the terms of the loan.

Based on the comments and its own analysis, the Board is adopting substantially revised rules for prepayment penalties. There are two components to the final rule. First, the final rule prohibits a prepayment penalty with a higher-priced mortgage loan or HOEPA loan if payments can change during the four-year period following consummation. Second, for all other higher-priced mortgage loans and HOEPA loans—loans whose payments may not change for four years after consummation—the final rule limits prepayment penalty periods to a maximum of two years following consummation, rather than five years as proposed. In addition, the final rule applies to this second category of loans two requirements for HOEPA loans that the Board proposed to apply to higher-priced mortgage loans: the penalty must be permitted by other applicable law, and it must not apply in the case of a refinancing by the same creditor or its affiliate.

The Board is not adopting the proposed rule requiring a prepayment penalty provision to expire at least sixty days before the first date on which a periodic payment amount may increase under the loan's terms. The final rule makes such a rule unnecessary. Under the final rule, if the consumer's payment may change during the first four years following consummation, a prepayment penalty is prohibited outright. If the payment is fixed for four years, the final rule limits a prepayment penalty period to two years, leaving the consumer a penalty-free window of at least two years before the payment may increase.

In addition, for the reasons discussed below, the Board is not adopting the proposed rule prohibiting a prepayment penalty where a consumer's verified DTI ratio, as of consummation, exceeds 50 percent. This restriction, however, will continue to apply to HOEPA loans, as provided by the statute.

Under 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. Final § 226.35(b)(2), which the Board is adopting under the authority of Section 129(l)(2), 15 U.S.C. 1639(l)(2), applies restrictions on prepayment penalties for higher-priced mortgage loans that are substantially the same as the restrictions that § 226.32(d)(6) and (7) apply on prepayment penalties for HOEPA loans. Accordingly, the Board is revising 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 § 226.35(b)(2) also is subject to a three-year right of rescission. (The right of rescission, however, does not extend to home purchase loans, construction loans, or certain refinancings with the same creditor.)

Public Comment

The Board received public input about the advantages and disadvantages of prohibiting or restricting prepayment penalties in testimony provided at the 2006 and 2007 hearings the Board conducted on mortgage lending, and in comment letters associated with these hearings. In the official notice of the 2007 hearing, the Board expressly asked for oral and written comment about the effects of a prohibition or restriction under HOEPA on prepayment penalties on consumers and on the type and terms of credit offered. 72 FR 30380, 30382 (May 31, 2007). Most consumer and community groups, as well as some state and local government officials and a trade association for community development financial institutions, urged the Board to prohibit prepayment penalties with subprime loans. By contrast, most industry commenters opposed prohibiting prepayment penalties or restricting them beyond requiring that they expire sixty days before reset, on the grounds that a prohibition or additional restrictions would reduce credit availability in the subprime market. Some industry commenters, however, stated that a three-year maximum prepayment penalty period would be appropriate.

In connection with the proposed rule, the Board asked for comment about the benefits and costs of prepayment penalties to consumers who have higher-priced mortgage loans, as well as about the costs and benefits of the specific restrictions proposed. Most financial institutions and their trade associations stated that consumers should be able to choose a loan with a prepayment penalty in order to lower their interest rate. Many of these commenters stated that prepayment penalties help creditors to manage prepayment risk, which in turn increases credit availability and lowers credit costs. Industry commenters generally opposed the proposed rule that would prohibit prepayment penalties in cases where a consumer's DTI ratio exceeds 50 percent. The few industry commenters that addressed the proposal to require that a prepayment penalty not apply in the case of a refinancing by the creditor or its affiliate opposed the provision. These commenters supported, or did not oppose, the proposal to require prepayment penalties to expire at least sixty days before any possible payment increase. Several financial institutions, an industry trade association, and a secondary-market investor recommended that the Board set a three-year maximum penalty period instead of a five-year maximum.

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

Public comments are discussed in greater detail throughout this section.

Discussion

For the reasons discussed below, the Board concludes that the fairness of prepayment penalty provisions on higher-priced mortgage loans and HOEPA loans depends to an important extent on the structure of the mortgage loan. It has been common in the subprime market to structure loans to have a short expected life span. This has been achieved by building in a significant payment increase just a few years after consummation. With respect to subprime loans designed to have shorter life spans, the injuries from prepayment provisions are potentially the most serious, as well as the most difficult for a reasonable consumer to avoid. For these loans, therefore, the Board concludes that the injuries caused by prepayment penalty provisions with subprime loans outweigh their benefits. With respect to subprime loans structured to have longer expected life spans, however, the Board concludes that the injuries from prepayment penalties are closer to being in balance with their benefits, warranting restrictions but not, at this time, a prohibition.

Background. Prepayment risk is the risk that a loan will be repaid before the end of the loan term, a major risk of mortgage lending. Along with default risk, it is the major risk of extending mortgage loans. When mortgages prepay, cash flow from loan payments may not offset origination expenses or discounts consumers were provided on fees or interest rates. Moreover, prepayment when market interest rates are declining, which is when borrowers are more likely to prepay, forces investors to reinvest prepaid funds at a lower rate. Furthermore, prepayment by subprime borrowers whose credit risk declines (for example, their equity or their credit score increases) leaves an investor holding relatively riskier loans.

Creditors seek to account for prepayment risk when they set loan interest rates and fees, and they may also seek to address prepayment risk with a prepayment penalty. A prepayment penalty is a fee that a borrower pays if he repays a mortgage within a specified period after origination. A prepayment penalty can amount to several thousand dollars. For example, a consumer who obtains a 3–27 ARM with a thirty-year term for a loan in the amount of $200,000 with an initial rate of 6 percent would have a principal balance of $194,936 at the end of the second year following consummation. If the consumer pays off the loan, a penalty of six months' interest on the remaining balance—close to six monthly payments—will cost the consumer about $5,850.[71] A penalty of this magnitude reduces a borrower's likelihood of prepaying and assures a return for the investor if the borrower does prepay.

Substantial injury. Prepayment penalty provisions have been very common on subprime loans. Almost three-quarters of loans in a large dataset of securitized subprime loan pools originated from 2003 through the first half of 2007 had a prepayment penalty provision.[72] These provisions cause many consumers who pay the penalty, as well as many consumers who cannot, substantial injuries. The risk of injury is particularly high for borrowers who receive loans structured to have short expected life spans because of a significant expected payment increase.

A borrower with a prepayment penalty provision who has reason to refinance while the provision is in effect must choose between paying the penalty or foregoing the refinance, either of which could be very costly. Paying the penalty could exact several thousand dollars from the consumer; financing the penalty through the refinance loan adds interest to that cost. When the consumer's credit score has improved, delaying the refinance until the penalty expires could mean losing or at least postponing an opportunity to lower the consumer's interest rate. Declining to pay the penalty also could mean foregoing or delaying a ''cash out'' loan that would consolidate several large unsecured debts at a lower rate or help the consumer meet a major life expense, such as for medical care. Borrowers who have no ability to pay or finance the penalty, however, have no choice but to forego or delay any benefits from refinancing.

Prepayment penalty provisions also exacerbate injuries from unaffordable or abusive loans. In the worst case, where a consumer has been placed in a loan he cannot afford to pay, delaying a refinancing could increase the consumer's odds of defaulting and, ultimately, losing the house.[73] Borrowers who were steered to loans with less favorable terms than they qualify for based on their credit risk face an ''exit tax'' for refinancing to improve their terms.

Prepayment penalty provisions can cause more injury with loans designed to have short expected life spans. With these loans, borrowers are particularly likely to want to prepay in a short time to avoid the expected payment increase. Moreover, in recent years, loans designed to have short expected life spans have been among the most difficult for borrowers to afford—even before their payment increases. Borrowers with 2–28 and 3–27 ARMs have been much more likely to become

[71] This is a typical contractual formula for calculating the penalty. There are other formulas for calculating the penalty, such as a percentage of the amount prepaid or of the outstanding loan balance (potentially reduced by the percentage (for example, 20 percent) that a borrower, by law or contract, may prepay without penalty). As explained further below, a consumer may pay a lower rate in exchange for having a provision providing for a penalty of this magnitude.

[72] Figure calculated from First American LoanPerformance data.

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

seriously delinquent than borrowers with fixed-rate subprime mortgages. In part, the difference reflects that borrowers receiving 2–28 and 3–27 ARMs have had lower average credit scores and less equity in their homes at origination. But the large difference also suggests that these shorter-term loans were more likely to be marketed and underwritten in ways that increase the risk of unaffordability. A prepayment penalty provision exacerbates this injury, especially because borrowers with lower credit scores are the most likely to have a need to refinance to extract cash.

Injury not reasonably avoidable. In the prime market, the injuries prepayment penalties cause are readily avoidable because lenders do not typically offer borrowers mortgages with prepayment penalty provisions. Indeed, in one large dataset of first-lien prime loans originated from 2003 to mid-2007 just six percent of loans had these provisions.[74] In a dataset of subprime securitized loans originated during the same period, however, close to three-quarters had a prepayment penalty provision.[75] Moreover, evidence suggests that a large proportion of subprime borrowers with prepayment penalty provisions have paid the penalty. Approximately 55 percent of subprime 2–28 ARMs in this same dataset originated from 2000 to 2005 prepaid while the prepayment penalty provision was in effect.[76] The data do not indicate how many consumers actually paid a penalty, or how much they paid. But the data suggest that a significant percentage of borrowers with subprime loans have paid prepayment penalties, which, as indicated above, can amount to several thousand dollars.

These figures raise a serious question as to whether a substantial majority of subprime borrowers have knowingly and voluntarily taken the very high risk of paying a significant penalty. While subprime borrowers receive some rate reduction for a prepayment penalty provision (as discussed at more length in the next subsection), they also have major incentives to refinance. They often have had difficulty meeting their regular obligations and experienced major life disruptions. Many would therefore anticipate refinancing to extract equity to consolidate their debts or pay a major expense; nearly 90 percent of subprime ARMs used for refinancings in recent years were ''cash out.''[77] In addition, many subprime borrowers would aspire to refinance for a lower rate when their credit risk declines (for example, their credit score improves, or their equity increases).

Prepayment penalties' lack of transparency also suggests that prepayment penalty provisions are often not knowingly and voluntarily chosen by subprime borrowers whose loans have them. In the subprime market, information on rates and fees is not easy to obtain. *See* part II.B. Information on prepayment penalties, such as how large they can be or how many consumers actually pay them, is even harder to obtain. The lack of transparency is exacerbated by originators' incentives—largely hidden from consumers—to ''push'' loans with prepayment penalty provisions and at the same time obscure or downplay these provisions. If the consumer seeks the lowest monthly payment—as the consumer in the subprime market often does—then the originator has a limited incentive to quote the payment for a loan without a prepayment penalty provision, which will tend to be at least slightly higher. Perhaps more importantly, lenders pay originators considerably larger commissions for loans with prepayment penalties, because the penalty assures the lender a larger revenue stream to cover the commission. The originator also has an incentive not to draw the consumer's attention to the prepayment penalty provision, in case the consumer should prefer a loan without it. Although the prepayment penalty provision must be disclosed on the post-application TILA disclosure, the consumer may not notice it amidst numerous other disclosures or may not appreciate its significance. Moreover, an unscrupulous originator may not disclose the penalty until closing, when the consumer's ability to negotiate terms is much reduced.

Even a consumer offered a genuine choice would have difficulty comparing the costs of subprime loans with and without a penalty, and would likely choose to place more weight on the more certain and tangible cost of the initial monthly payment. There is a limit to the number of factors a consumer can reasonably be expected to consider, so the more complex a loan the less likely the consumer is to consider the prepayment penalty. For example, an FTC staff study found that consumers presented with mortgage loans with more complex terms were more likely to miss or misunderstand key terms.[78]

These concerns are magnified with subprime loans structured to have short expected life spans, which will have variable rates (such as 2–28 and 3–27 ARMs) or other terms that can increase the payment. Adjustable-rate mortgages are complicated for consumers even without prepayment penalties. A Federal Reserve staff study suggests that borrowers with ARMs underestimate the amount by which their interest rates can change.[79] The study also suggests that the borrowers most likely to make this mistake have a statistically higher likelihood of receiving subprime mortgages (for example, they have lower incomes and less education).[80] Adding a prepayment penalty provision to an already-complex ARM product makes it less likely the consumer will notice, understand, and consider this provision when making decisions. Moreover, the shorter the period until the likely payment increase, the more the consumer will have to focus attention on the adjustable-rate feature of the loan and the less the consumer may be able to focus on other features.

Moreover, subprime mortgage loans designed to have short expected life spans appear more likely than other types of subprime mortgages to create incentives for abusive practices. Because these loans create a strong incentive to refinance in a short time, they are likely to be favored by originators who seek to ''flip'' their clients through repeated refinancings to increase fee revenue; prepayment penalties are frequently associated with such a strategy.[81] Moreover, 2–28 and

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[74] Figure calculated from McDash Analytics data.

[75] Figure calculated from First American LoanPerformance data.

[76] *Id.*

[77] *Id.* It is not possible to discern from the data whether the cash was used only to cover the costs of refinancing or also for other purposes. *See also Subprime Refinancing* at 233 (reporting that 49 percent of subprime refinance loans involve equity extraction, compared with 26 percent of prime refinance loans); *Subprime Outcomes* at 368–371 (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 551–52 (citing survey evidence that borrowers with subprime loans have increased incidence of major medical expenses, major unemployment spells, and major drops in income).

[78] *Improving Consumer Mortgage Disclosures* at 74 (''[R]espondents had more difficulty recognizing and identifying mortgage cost in the complex-loan scenario. This implies that borrowers in the subprime market may have more difficulty understanding their loan terms than borrowers in the prime market. The difference in understanding, however, would be due largely to differences in the complexities of the loans, rather than the capabilities of the borrowers.'').

[79] Brian Bucks and Karen Pence, *Do Borrowers Understand their Mortgage Terms?*, Journal of Urban Economics (forthcoming 2008).

[80] *Id.*

[81] *See generally* U.S. Dep't of Hous. & Urban Dev. & U.S. Dep't of Treasury, *Recommendations to Curb*

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3–27 ARMs were marketed to borrowers with low credit scores as ''credit repair'' products, obscuring the fact that a prepayment penalty provision would inhibit or prevent the consumer who improved his credit score from refinancing at a lower rate. These loans were also associated more than other loan types with irresponsible underwriting and marketing practices that contributed to high rates of delinquency even before the consumer's payment increased.

Subprime loans designed to have short expected life spans also attracted consumers who are more vulnerable to abusive prepayment penalties. Borrowers with 2–28 and 3–27 ARMs had lower credit scores than borrowers with any other type of subprime loan.[82] These borrowers include consumers with the least financial sophistication and the fewest financial options. Such consumers are less likely to scrutinize a loan for a restriction on prepayment or negotiate the restriction with an originator, who in any event has an incentive to downplay its significance.

Injury not outweighed by countervailing benefits to consumers or to competition. The Board concludes that prepayment penalties' injuries outweigh their benefits in the case of higher-priced mortgage loans and HOEPA loans designed with planned or potential payment increases after just a few years. For other types of higher-priced and HOEPA loans, however, the Board concludes that the injuries and benefits are much closer to being in equipoise. Thus, as explained further in the next section, the final rule prohibits penalties in the first case and limits them to two years in the second.

Prepayment penalties can increase market liquidity by permitting creditors and investors to price directly and efficiently for prepayment risk. This liquidity benefit is more significant in the subprime market than in the prime market. Prepayment in the subprime market is motivated by a wider variety of reasons than in the prime market, as discussed above, and therefore is subject to more uncertainty. In principle, prepayment penalty provisions allow creditors to charge most of the prepayment risk only to the consumers who actually prepay, rather than charging all of the risk in the form of higher interest rates or up-front fees for all consumers. The extent to which creditors have actually passed on lower rates and fees to consumers with prepayment penalty provisions in their loans is debated and, moreover, inherently difficult to measure. With limited exceptions, however, available studies, discussed at more length below, have shown consistently that loans with prepayment penalties carry lower rates or APRs than loans without prepayment penalties having similar credit risk characteristics.[83]

Evidence of lower rates or APRs is not sufficient to demonstrate that penalties provide a net benefit to consumers. Some consumers may not have chosen the lower rates or APRs voluntarily and may have preferred *ex ante*, had they been properly informed, to have no prepayment penalty provision and somewhat higher rates or fees. Borrowers with these provisions who hold their loans past the penalty period are likely better off because they have lower rates and do not incur a prepayment penalty; but the benefit these borrowers receive may be small compared to the injury suffered by the many borrowers who pay the penalty, or who cannot pay it and are locked into an inappropriate or unaffordable loan. It does appear, however, that prepayment penalty provisions provide some benefit to at least some consumers in the form of reduced rates and increased credit availability.

In the case of higher-priced mortgage loans and HOEPA loans designed to have short expected life spans, the Board concludes that these potential benefits do not outweigh the injuries to consumers. Available studies generally have found reductions in interest rate or APR associated with subprime 2–28 ARMs and 3–27 ARMs to be minimal, ranging from 18 to a maximum of 29 basis points, with one study finding no rate reduction on such loans originated by brokers.[84] The one available (but unpublished) study to compare the rate reduction to the cost of the penalty itself found a net cost to the consumer with 2–28 and 3–27 ARMs.[85] The minimal rate reductions strengthen doubt that the high incidence of penalty provisions was the product of informed consumer choice. Moreover, for the reasons discussed above, prepayment penalties are likely to cause the most significant, and least avoidable, injuries when coupled with loans designed to have short expected life spans, which have proved to be the riskiest loans for consumers. On balance, therefore, the Board believes these injuries outweigh potential benefits.

For higher-priced mortgage loans and HOEPA loans structured to have longer expected life spans, however, the Board concludes that the injuries and benefits are closer to being in balance. Studies that analyze both fixed-rate mortgages and 2–28 and 3–27 ARMs show a more significant reduction of rates and fees for fixed-rate mortgages for loans with prepayment penalties, ranging from 38 basis points[86] to 60 basis points.[87] Moreover, longer-term ARMs and fixed-rate mortgages have had significantly lower delinquency rates than 2–28 and 3–27 ARMs, suggesting these mortgages are more likely to be affordable to consumers. In addition, mortgages

Predatory Home Mortgage Lending 73 (2000) (''Loan flipping generally refers to repeated refinancing of a mortgage loan within a short period of time with little or no benefit to the borrower.''), available at *http://www.huduser.org/publications/pdf/treasrpt.pdf.*

[82] Figures calculated from First American LoanPerformance data about securitized subprime pools show that the median FICO score was 627 for fixed-rate loans and 612 for short-term hybrid ARMs (2–28 and 3–27 ARMS).

[83] *See* Chris Mayer, Tomasz Piskorski, and Alexei Tchistyi, *The Inefficiency of Refinancing: Why Prepayment Penalties Are Good for Risky Borrowers* (Apr. 28, 2008) (*Why Prepayment Penalties Are Good*), *http://www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/3065/Inefficiency%20of%20Refinancing%2Epdf;* Gregory Elliehausen, Michael E. Staten, and Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages,* 60 Journal of Economics and Business 33 (2008) (*Effect of Prepayment Penalties*); Michael LaCour-Little, *Prepayment Penalties in Residential Mortgage Contracts: A Cost-Benefit Analysis* (Jan. 2007) (unpublished) (*Cost-Benefit Analysis*); Richard F. DeMong and James E. Burroughs, *Prepayment Fees Lead to Lower Interest Rates,* Equity (Nov./Dec. 2005), available at *http://www.commerce.virginia.edu/faculty_research/faculty_homepages/DeMong/Prepaymentsand InterestRates.pdf* (*Prepayment Fees Lower Rates*); *but see* Keith E. Ernst, Center for Responsible Lending, *Borrowers Gain No Interest Rate Benefit from Prepayment Penalties on Subprime Mortgages* (2005), *http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf* (*No Interest Rate Benefit*).

[84] *See Effect of Prepayment Penalties* 43 (finding that the presence of a prepayment penalty reduced risk premiums by 18 basis points for hybrid loans and 13 basis points for variable-rate loans); *Prepayment Fees Lower Rates* 5 (stating that, for first-lien subprime loans with a thirty-year term, the presence of a prepayment penalty reduced the APR by 29 basis points for adjustable-rate loans and 20 basis points for interest-only loans).

[85] *Cost-Benefit Analysis* 26 (''For the [2–28] ARM product, the total interest rate savings is significantly less than the amount of the expected prepayment penalty; for the [3–28] ARM product, the two values are approximately equal.'').

[86] *Effect of Prepayment Penalties* 43. *See also Cost-Benefit Analysis* 24 (finding the total estimated interest rate savings for fixed-rate loans to be 51 basis points for retail-originated loans and 33 basis points for broker-originated loans).

[87] *Prepayment Fees Lower Rates* 5. *See also Why Prepayment Penalties Are Good* 25 & fig. 4 (finding that, depending on the borrower's FICO score, fixed-rate loans with prepayment penalties had interest rates that were about 50 basis points (where FICO score 680 or higher) to about 70 basis points (where FICO score less than 620) lower than mortgages without prepayment penalties); *but see No Interest Rate Benefit* (finding, for subprime fixed-rate loans, that interest rates for purchase loans with a prepayment penalty were between 39 and 51 basis points higher than for such loans without a penalty and that for refinance loans there was no statistically significant difference in the interest rates paid).

designed to have longer life spans create less opportunity for flipping and other abuses, and the borrowers offered these loans may be less vulnerable to abuse. These borrowers have had higher credit scores and therefore more options, and their preference for a longer-lived loan may imply that they have a longer-term perspective and a more realistic assessment of their situation. In fact, a smaller proportion of borrowers with subprime fixed-rate mortgages with penalty provisions originated between 2000 and 2005 prepaid in the first two years (about 35 percent) than did borrowers with subprime 2–28 ARMs with penalty provisions (about 55 percent).[88] Therefore, in the case of shorter prepayment penalty provisions on loans structured to have longer life spans, the Board does not conclude at this time that the injuries from these provisions outweigh the benefits.

The Final Rule

For both higher-priced mortgage loans and HOEPA loans, the final rule prohibits prepayment penalties if periodic payments can change during the first four years following loan consummation. For all other higher-priced mortgage loans and HOEPA loans, the final rule limits the prepayment penalty period to two years after loan consummation and also requires that a prepayment penalty not apply if the same creditor or its affiliate makes the refinance loan. For HOEPA loans, the final rule retains the current prohibition of prepayment penalties where the borrower's DTI ratio at consummation exceeds 50 percent; the Board is not adopting this prohibition for higher-priced mortgage loans. The final rule sets forth the foregoing prepayment penalty rules in two separate sections: For HOEPA loans, in § 226.32(d)(7), and for higher-priced mortgage loans, in § 226.35(b)(3).

TILA Section 129(c)(2)(C), 15 U.S.C. 1639(c)(2)(C), limits the maximum prepayment penalty period with HOEPA loans to five years following consummation. The Board proposed to apply this HOEPA provision to higher-priced mortgage loans. Commenters generally stated that a five-year maximum prepayment period was too long. Some consumer organizations, an association of credit unions, and a federal banking regulatory agency recommended a two-year limit on prepayment penalty periods. A few consumer organizations recommended a one-year maximum length. Although a financial services trade association supported a five-year maximum, several financial institutions and mortgage banking trade associations and a government-sponsored enterprise stated that three years would be an appropriate maximum period for prepayment penalties with higher-priced mortgage loans.

As discussed above, the Board concludes that the injuries from prepayment penalty provisions that consumers cannot reasonably avoid outweigh these provisions' benefits with respect to higher-priced mortgage loans and HOEPA loans structured to have short expected life spans. Accordingly, the final rule prohibits a prepayment penalty provision with a higher-priced mortgage loan or a HOEPA loan whose payments may change during the first four years following consummation.[89] A four-year discount period is not common, but a three-year period was common at least until recently. Using a three-year period in the regulation, however, might simply encourage the market to structure loans with discount periods of three years and one day. Therefore, the Board adopts a four-year period in the final rule as a prophylactic measure.

The prohibition applies to loans with potential payment changes within four years, including potential increases and potential declines; the prohibition is not limited to loans where the payment can increase but not decline. The Board is concerned that such a limitation might encourage the market to develop unconventional repayment schedules for HOEPA loans and higher-priced mortgage loans that are more difficult for consumers to understand, easier for originators to misrepresent, or both. The final rule also refers specifically to periodic payments of principal or interest or both, to distinguish such payments from other payments, including amounts directed to escrow accounts. Staff commentary lists examples showing whether prepayment penalties are permitted or prohibited in particular circumstances where the amount of the periodic payment can change. The commentary also provides examples of changes that are not deemed payment changes for purposes of the rule.[90]

With respect to loans structured to have longer expected life spans, the Board concludes that the injuries from prepayment penalty provisions that are short relative to the expected life span are closer to being in balance with their benefits. Accordingly, for loans for which the payment may not change, or may change only after four or more years, the Board is not banning prepayment penalties. Instead, it is seeking to ensure the benefits of penalty provisions on these loans are in line with the injuries they can cause by limiting the potential for injury to two years from consummation.

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

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

[88] Figures calculated from First American LoanPerformance data. About 90 percent of the penalty provisions on the fixed-rate loans applied for at least two years.

[89] This rule is stricter than HOEPA's statutory provision on prepayment penalties for HOEPA loans. This provision permits such penalties under certain conditions regardless of a potential payment change within the first four years. Section 129(l)(2) authorizes the Board, however, to prohibit acts or practices it finds to be unfair or deceptive in connection with mortgage loans—including HOEPA loans. Since HOEPA's restrictions on prepayment penalty provisions were adopted, much has changed to make these provisions more injurious to consumers and these injuries more difficult to avoid. The following risk factors became much more common in the subprime market: ARMs with payments that reset after just two or three years; securitization of subprime loans under terms that reduce the originator's incentive to ensure the consumer can afford the loan; and mortgage brokers with hidden incentives to ''push'' penalty provisions.

[90] As discussed above, the final rule sets forth the prepayment penalty rules in two separate sections. For HOEPA loans, § 226.32(d)(7) lists conditions that must be met for the general penalty prohibition in § 226.32(d)(6) not to apply. For higher-priced mortgage loans, § 226.35(b)(2) prohibits a penalty described in § 226.32(d)(6) unless the conditions in § 226.35(b)(i) and (ii) are met. To ensure consistent interpretation of the separate sections, the staff commentary to § 226.35(b)(2) cross-references the payment-change examples and exclusions in staff commentary to § 226.32(d)(7). The examples in staff commentary to § 226.32(d)(7)(iv) refer to a condition that final § 226.35(b)(2) does not include, however—the condition that, at consummation, the consumer's total monthly debt payments may not exceed 50 percent of the consumer's monthly gross income. The staff commentary to § 226.35(b)(2) clarifies this difference.

Sixty-day window. The Board does not believe that the proposed requirement that a prepayment penalty period expire at least sixty days before a potential payment increase would adequately protect consumers with loans where the increase was expected shortly. As discussed, these loans, such as 2–28 ARMs, will tend to attract consumers who have a short planning horizon and intend to avoid the payment increase by refinancing. If provided only a brief penalty-free window to refinance before the increase (as proposed, a window in months 23 and 24 for a 2–28 ARM), the consumer deciding whether to accept a loan with a penalty provision—assuming the consumer was provided a genuine choice—must predict quite precisely when he will want to refinance. If the consumer believes he will want to refinance in month 18 and that his credit score, home equity, and other indicators of credit quality will be high enough then to enable him to refinance, then the consumer probably would be better off with a loan without a penalty provision. If, however, the consumer believes he will not be ready or able to refinance until month 23 or 24 (the penalty-free window), he probably would be better off accepting the penalty provision. It is not reasonable to expect consumers in the subprime market to make such precise predictions. Moreover, for transactions on which prepayment penalties are permitted by the final rule, a sixty-day window would be moot because the penalty provision may not exceed two years and the payment on a loan with a penalty provision may not change during the first four years following consummation.[91]

Refinance loan from same creditor. The Board is adopting with minor revisions the proposed requirement that a prepayment penalty not apply when a creditor refinances a higher-priced mortgage loan the creditor or its affiliate originated. HOEPA imposes this requirement in connection with HOEPA loans. 15 U.S.C. 1639(c)(2)(B).

Some large financial institutions and financial institution trade associations that commented opposed the proposal. A large bank stated that the requirement would not prevent loan flipping and that mortgage brokers would easily circumvent the rule by directing repeat customers to a different creditor each time. A mortgage bankers' trade association and a large bank stated that the requirement would prevent customers from returning to the same institution with which they have existing relationships. Another large bank stated that the rule would place lenders at a competitive disadvantage when trying to refinance the loan of an existing customer.

Requiring that a prepayment penalty not apply when a creditor refinances a loan it originated will discourage originators from seeking to ''flip'' a higher-priced mortgage loan. To prevent 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. Although creditors may waive a prepayment penalty when they refinance a loan that they originated to a consumer, consumers who refinance with the same creditor may be charged a prepayment penalty even if a creditor or mortgage broker has told the consumer that the prepayment penalty would be waived in that circumstance.[92]

The final rule requires that a prepayment penalty not apply where a creditor or its affiliate refinances a higher-priced mortgage loan that the creditor originated to the consumer. The final rule is based on TILA Section 129(c)(2)(B), 15 U.S.C. 1639(c)(2)(B), which provides that a HOEPA loan may contain a prepayment penalty ''if the penalty applies only to a prepayment made with amounts obtained by the consumer by means other than a refinancing by the creditor under the mortgage, or an affiliate of that creditor.'' The Board notes that TILA Section 129(c)(2)(B), 15 U.S.C. 1639(c)(2)(B), applies regardless of whether the creditor still holds the loan at the time of a refinancing by the creditor or an affiliate of the creditor. In some cases, a creditor's assignees are the ''true creditor'' funding the loan; moreover, the rule prevents loan transfers designed to evade the prohibition.

TILA Section 129(c)(2)(B) does not prohibit a creditor from refinancing a loan it or its affiliate originated but rather requires that a prepayment penalty not apply in the event of a refinancing by the creditor or its affiliate. To make clear that the associated regulation, § 226.32(d)(7)(ii), does not prohibit a creditor from refinancing a loan that the creditor (or an affiliate of the creditor) originated, the Board is revising the text of that regulation somewhat. Final § 226.32(d)(7)(ii) states that a HOEPA loan may provide for a prepayment penalty if the prepayment penalty provision will not apply if the source of the prepayment funds is a refinancing by the creditor or an affiliate of the creditor. This change clarifies, without altering, the meaning of the provision and is technical, not substantive, in nature. Final § 226.35(b)(2)(ii)(B) applies to higher-priced mortgage loans rather than to HOEPA loans but mirrors final § 226.32(d)(7)(ii) in all other respects.

Debt-to-income ratio. Under the proposed rule, a higher-priced mortgage loan could not include a prepayment penalty provision if, at consummation, the consumer's DTI ratio exceeds 50 percent. Proposed comments would have given examples of funds and obligations that creditors commonly classify as ''debt'' and ''income'' and stated 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.''

Most banking and financial services trade associations and several large banks stated that the Board should not prohibit prepayment penalties on higher-cost loans where a consumer's DTI ratio at consummation exceeds 50 percent. Several of these commenters stated that the proposed rule would disadvantage a consumer living on a fixed income but with significant assets, including many senior citizens. Some of these commenters stated that the proposed rule would disadvantage consumers in areas where housing prices are relatively high. Some consumer organizations also objected to the proposed DTI-ratio requirement, stating that the requirement would not protect low-income borrowers with a DTI ratio equal to or less than 50 percent but limited residual income.

The Board is not adopting a specific DTI ratio in the rule prohibiting disregard of repayment ability. *See* part IX.B. For the same reasons, the Board is not adopting the proposed prohibition of a prepayment penalty for all higher-priced mortgage loans where a consumer's DTI ratio at consummation exceeds 50 percent. The Board is, however, leaving the prohibition in

[91] The Board sought comment on whether it should revise § 226.20(c) or draft new disclosure requirements to reconcile that section with the proposed requirement that a prepayment penalty provision expire at least sixty days prior to the date of the first possible payment increase. This issue is also moot.

[92] This concern is evident, for example, in a settlement agreement that ACC Capital Holdings Corporation and several of its subsidiaries, including Ameriquest Mortgage Company (collectively, the Ameriquest Parties) made in 2006 with 49 states and the District of Columbia. The Ameriquest Parties agreed not to make false, misleading, or deceptive representations regarding prepayment penalties and specifically agreed not to represent that they will waive a prepayment penalty at some future date, unless that promise is made in writing and included in the terms of a loan agreement with a borrower. *See, e.g., Iowa ex rel. Miller* v. *Ameriquest Mortgage Co.*, No. 05771 EQCE–053090 at 18 (Iowa D. Ct. 2006) (Pls. Pet. 5).

place as it applies to HOEPA loans, as this prohibition is statutory, TILA Section 129(c)(2)(A)(ii), and its removal does not appear warranted at this time.

This statute provides that for purposes of determining whether at consummation of a HOEPA loan a consumer's DTI ratio exceeds 50 percent, 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 pay stub or other payment record supplied by the consumer). The Board proposed to adopt a stronger standard that would require creditors to verify the consumer's income and expenses in accordance with verification rules that the Board proposed and is adopting in final § 226.34(a)(4)(ii), together with associated commentary. Although the Board requested comment about the proposal to revise § 226.32(d)(7)(iii) and associated commentary, commenters did not discuss this proposal.

As proposed, the Board is strengthening the standards that § 226.32(d)(7)(iii) establishes for verifying the consumer's income and expenses when determining whether a prepayment penalty is prohibited because the consumer's DTI ratio exceeds 50 percent at consummation of a HOEPA loan. There are three bases for adopting an income verification requirement that is stronger than the standard TILA Section 129(c)(2)(A)(ii) establishes. 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 IX.B, the Board believes that relying solely on the income statement on the application is unfair to the consumer, regardless of whether the consumer is employed by another person, self-employed, or unemployed. Second, the Board has a broad authority under TILA 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, establishing a single standard for verifying a consumer's income and obligations for HOEPA loans and higher-priced mortgage loans will facilitate compliance.

For the foregoing reasons, for HOEPA loans, final § 226.32(d)(7)(iii) requires creditors to verify that the consumer's total monthly debt payments do not exceed 50 percent of the consumer's monthly gross income using the standards set forth in final § 226.34(a)(4)(ii). The Board also is revising the commentary associated with § 226.32(d)(7)(iii) to cross-reference certain commentary associated with § 226.34(a)(4).

Disclosure. For reasons discussed above, the Board does not believe that disclosure alone is sufficient to enable consumers to avoid injury from a prepayment penalty. There is reason to believe, however, that disclosures could more effectively increase transparency.[93] The Board will be conducting consumer testing to determine how to make disclosures more effective. As part of this process, the Board will consider the recommendation from some commenters that creditors who provide loans with prepayment penalties be required to disclose the terms of a loan without a prepayment penalty.

D. Escrows for Taxes and Insurance—§ 226.35(b)(3)

The Board proposed in § 226.35(b)(3) to require a creditor to establish an escrow account for property taxes and homeowners insurance on a higher-priced mortgage loan secured by a first lien on a principal dwelling. Under the proposal, a creditor may allow a consumer to cancel the escrow account, but no sooner than 12 months after consummation. The Board is adopting the rule as proposed and adding limited exemptions for loans on cooperative shares and, in certain cases, condominium units.

The final rule requires escrows for all covered loans secured by site-built homes for which creditors receive applications on or after April 1, 2010, and for all covered loans secured by manufactured housing for which creditors receive applications on or after October 1, 2010.

Public Comments

Many community banks and mortgage brokers as well as several industry trade associations opposed the proposed escrow requirement. Many of these commenters contended that mandating escrows is not necessary to protect consumers. They argued that consumers are adequately protected by the proposed requirement to consider a consumer's ability to pay tax and insurance obligations under § 226.35(b)(1), and by a disclosure of estimated taxes and insurance they recommended the Board adopt. Commenters also contended that setting up an escrow infrastructure would be very expensive; creditors will either pass on these costs to consumers or decline to originate higher-priced mortgage loans.

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

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

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

Discussion

As commenters confirmed, it is common for creditors to offer escrows in the prime market, but not in the subprime market. The Board believes that this discrepancy is not entirely the result of consumers in the subprime market making different choices than consumers in the prime market. Rather, subprime consumers, whether they would wish to escrow or not, face a market where competitive forces have prevented significant numbers of creditors from offering escrows at all. In such a market, consumers suffer significant injury, especially, but not only, those who are not experienced handling property taxes and insurance on their own and are therefore least able to avoid these injuries. The Board finds that these injuries outweigh the costs to consumers of offering them escrows. For these reasons, the Board finds that it is unfair for a creditor to make a higher-priced mortgage loan without presenting

[93] For example, an FTC study based on quantitative consumer testing using several fixed-rate loan scenarios found that improving a disclosure of the prepayment penalty provision increased the percentage of participants who could tell that they would pay a prepayment penalty if they refinanced. *Improving Mortgage Disclosures* 109.

the consumer a genuine opportunity to escrow. In order to ensure that the opportunity to escrow is genuine, the final rule requires that creditors establish escrow accounts for first-lien higher-priced mortgage loans for at least twelve months. The Board believes that consumers, creditors, and investors will all benefit from this requirement.

Lack of escrow opportunities in the subprime market. Relative to the prime market, few creditors in the subprime market offer consumers the opportunity to escrow. The Board believes that, absent a rule requiring escrows, market forces alone are unlikely to drive significant numbers of creditors to begin to offer escrows in the subprime market. Consumers in the subprime market tend to shop based on monthly payment amounts, rather than on interest rates.[94] So creditors who are active in the subprime market, and who can quote low monthly payments to a prospective borrower, have a competitive advantage over creditors that quote higher monthly payments. A creditor who does not offer the opportunity to escrow (and thus quotes monthly payments that do not include amounts for escrows) can quote a lower monthly payment than a creditor who does offer an opportunity to escrow (and thus quotes a higher monthly payment that includes amounts for escrow). Consequently, creditors in the subprime market who offer escrows may be at a competitive disadvantage to creditors who do not.

Creditors who offer escrows could try to overcome this competitive disadvantage by advertising the availability and benefits of escrows to subprime consumers. Yet offering escrows entails some significant cost to the creditor. The creditor must either outsource servicing rights to third party servicers and lose servicing revenue, or make a large initial investment to establish an escrow infrastructure in-house. According to comments from some creditors, the cost to set up an escrow infrastructure could range between one million dollars and $16 million for a large creditor. While escrows improve loan performance[95] and offer creditors assurance that the collateral securing the loan is protected, those advantages alone have not proven sufficient incentive to make escrowing widespread in the subprime market. Rather, if a creditor is to recoup its costs for offering an opportunity to escrow, the creditor must convince a significant number of subprime consumers that they would be better served by accepting a higher monthly payment with escrows rather than a lower monthly payment without escrows. Yet consumers' focus on the lowest monthly payments in the subprime market, and the lack of familiarity with escrows, could make it difficult to convince consumers to accept the higher payment. In addition, the creditor who offered escrows would be vulnerable to competitors' attempts to lure away existing borrowers by quoting a lower monthly payment without disclosing that the payment does not include amounts for escrows. Nor could a creditor who offered escrows necessarily count on consumers who wanted to escrow finding the creditor on their own. If only a small minority of creditors offer escrows, consumers would, on average, have to contact many creditors in order to find one that offers escrows and many consumers might reasonably give up the search before they were successful.

Under these conditions, creditors are unlikely to offer escrows unless their competitors are required to offer escrows. The Board believes that creditors' failure to establish a capacity to escrow is a collective action problem; creditors would likely be better off if escrows were widely available in the subprime market, but most creditors who have not offered escrows lack the necessary incentive to invest in the requisite systems unless their competitors do. This is the context for the Board's finding that it is unfair for a creditor to make a higher-priced mortgage loan without offering an escrow.

Substantial injury. A creditor's failure to offer escrows can cause consumers substantial injury. The lack of escrows in the subprime market increases the risk that consumers will base borrowing decisions on unrealistically low assessments of their mortgage-related obligations. Brokers and loan officers operating in a market where escrows are not common generally quote monthly payments of only principal and interest. These originators have little incentive to disclose or emphasize additional obligations for taxes and insurance. Therefore, many consumers will decide whether they can afford the offered loan on the basis of misleadingly low payment quotes, making it more likely that they will obtain mortgages they cannot afford. This risk is particularly high for first time homebuyers, who lack experience with the obligations of homeownership. The risk is also elevated for homeowners who currently have prime loans and contribute to an escrow. If their circumstances change and they refinance in the subprime market, they may not be aware that payments quoted to them do not include amounts for escrow. For example, current homeowners who have substantial unsecured consumer debt, but who also have equity in their homes, can be especially vulnerable to ''loan flipping'' because they may find a cash-out refinance offer attractive. Yet if they assumed, erroneously, that the monthly payment quoted to them included amounts for escrows, they would not be able to evaluate the true cost of the loan product being offered.

The lack of escrows in the subprime market also makes it more likely that certain consumers will not be able to handle their mortgage obligations including taxes and insurance. Subprime consumers, by definition, are those who have experienced some difficulty in making timely payments on debt obligations. For this reason, some consumers may prefer to escrow if offered a choice, especially if they know from personal experience that they have difficulty saving on their own, paying their bills on-time, or both. Without an escrow, these consumers may be at greater risk that a servicer will impose costly force-placed homeowners insurance or the local government will seek to foreclose to collect unpaid taxes. Consumers with unpaid property tax or insurance bills are particularly vulnerable to predatory lending practices: originators offering them a refinancing with ''cash out'' to cover their tax and insurance obligations can take advantage of their urgent circumstances. The consumers who cannot or will not borrow more (for example, because they lack the equity) face default and a forced sale or foreclosure.

Injury not reasonably avoidable. Consumers cannot reasonably avoid the injuries that result from the lack of escrows. As described above, originators in the subprime market have strong incentives to quote only principal and interest payment amounts, and much

[94] *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.'').

[95] An industry representative at the Board's 2007 hearing indicated that her company's internal analysis showed that escrows clearly improved loan performance. *Home Ownership and Equity Protection Act (HOEPA): Public Hearing*, at 66 (June 14, 2007) (statement of Faith Schwartz, Senior Vice President, Option One Mortgage Corp.), available at *http://federalreserve.gov/events/publichearings/hoepa/2007/20070614/transcript.pdf.* Also, the Credit Union National Association and California and Nevada Credit Union Leagues comment letters note that ''[o]verall, loans with escrow accounts are likely to perform better than loans without these accounts.''

weaker incentives to inform consumers about tax and insurance obligations since doing so could put them at a competitive disadvantage. Consumers may either be left unaware of the magnitude of their taxes and insurance obligations, or may not realize that amounts for taxes and insurance are not being escrowed for them if they are accustomed to the prime market's practice of escrowing. And, in a market where few creditors offer escrows and advertise their availability, consumers who would prefer to escrow may give up trying to find a creditor who offers escrows. Given the market they face, subprime consumers have little ability or incentive to shop for a loan with escrows, and thus cannot reasonably avoid a loan that does not offer escrows.

Injury not outweighed by countervailing benefit to consumers or to competition. The Board recognizes that creditors incur costs in initiating escrow capabilities and that creditors who do not escrow can pass their cost savings on to consumers. Creditors that offer escrows in-house may incur potentially substantial costs in setting up or acquiring the necessary systems, although they may also gain some additional servicing revenue. Creditors that outsource servicing of escrow accounts to third parties incur some cost and forgo servicing revenue.

In addition, there are some potential costs to consumers. Servicers may at times collect more funds than needed or fail to pay property taxes and insurance when due, causing consumers to incur penalties and late fees. Congress has expressly authorized the Department of Housing and Urban Development (HUD) to address these problems through section 10 of the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. 2609, which limits amounts that may be collected for escrow accounts; requires servicers to provide borrowers annual statements of the escrow balance and payments for property taxes and homeowners insurance; and requires a mortgage servicer to provide information about anticipated activity in the escrow accounts for the coming year when it starts to service a loan. RESPA also provides consumers the means to resolve complaints by filing a ''qualified written request'' with the servicer. The Board expects that the number of qualified written requests may increase after the final rule takes effect.

On the other hand, there is evidence, described above, that where escrows are used they improve loan performance to the advantage of creditors, investors, and consumers alike. This appears to be an important reason that escrows are common in the prime market and often required by the creditor. Loans with escrows generally perform better than loans without because escrows make it more likely that consumers will be able to pay their obligations. By contrast, when consumers are faced with unpaid taxes and insurance, they may need to tap into their home equity to pay these expenses and may become vulnerable to predatory lending. In the worst cases, consumers may lose their homes to foreclosure for failure to pay property taxes. For these reasons, the Board finds that the benefits from escrows outweigh the costs associated with requiring them.

The Final Rule

The final rule prohibits a creditor from extending a first-lien higher-priced mortgage loan secured by a principal dwelling without escrowing property taxes, homeowners insurance, and other insurance obligations required by the creditor. Creditors have the option to allow for cancellation of escrows at the consumer's request, but no earlier than 12 months after consummation of the loan transaction. The Board is adopting an exemption for loans secured by cooperative shares and a partial exemption for loans secured by condominium units. The final rule defines ''escrow account'' by reference to the definition of ''escrow account'' in RESPA. Moreover, RESPA's rules for administering escrow accounts (including how creditors handle disclosures, initial escrow deposits, cushions, and advances to cover shortages) apply. The final rule also complements the National Flood Insurance Program requirement that flood insurance premiums be escrowed if the creditor requires escrow for other obligations such as hazard insurance.[96]

The rule is intended to address the consumer injuries described above caused by the lack of a genuine opportunity to escrow in the subprime market. The rule assures a genuine opportunity to escrow by establishing a market that provides widespread escrows through a requirement that every creditor that originates higher-priced mortgage loans secured by a first lien on a principal dwelling establish an escrow with each loan. The Board proposed to limit the rule to first-lien higher-priced mortgage loans because creditors in the prime market have traditionally required escrow accounts on first-lien mortgage loans as a means of protecting the lender's interest in the property securing the loan. The final rule adopts this approach. A mandatory escrow account on a first-lien loan ensures that funds are set aside for payment of property taxes and insurance premiums and eliminates the need to require an escrow on second lien loans. One commenter asked the Board to clarify in the final rule that creditors are not obligated to escrow payments for optional items that the consumer may choose to purchase at its discretion, such as an optional debt-protection insurance or earthquake insurance. A commentary provision has been added to clarify that creditors and servicers are not required to escrow optional insurance items chosen by the consumer and not otherwise required by creditor. *See* comment to § 226.35(b)(4)(i).

The Board recognizes that escrows can impose certain financial costs on both creditors and borrowers. Creditors are likely to pass on to consumers, either in part or entirely, the cost of setting up and maintaining escrow systems, whether done in-house or outsourced. The Board also recognizes that prohibiting consumers from canceling before 12 months have passed will impose costs on individual consumers who prefer to pay property taxes and insurance premiums on their own, and to earn interest on funds that otherwise would be escrowed.[97] By paying property taxes and insurance premiums directly, consumers are better able to monitor that their payments are credited on time, thus limiting the likelihood, and related cost, of servicing mistakes and abuses. In addition, homebuyers do not need as much cash at closing when they are not required to have an escrow account.

The Board believes, however, that the benefits of the rule outweigh these costs. Moreover, the rule preserves some degree of consumer choice by permitting a creditor to provide the consumer an option to cancel an escrow account 12 or more months after consummation. The Board considered alternatives that would avoid requiring a creditor to set up an escrow system,

[96] Congress authorized NFIP through the National Flood Insurance Act of 1968 (42 U.S.C. 4001), which provides property owners with an opportunity to purchase flood insurance protection made available by the federal government for buildings and their contents. NFIP requires all federally regulated private creditors and government-sponsored enterprises (GSEs) that purchase loans in the secondary market to ensure that a building or manufactured home and any applicable personal property securing a loan in a special flood hazard area are covered by adequate flood insurance for the term of the loan. The flood insurance requirements do not apply to creditors or servicers that are not federally regulated and that do not sell loans to Fannie Mae and Freddie Mac or other GSEs.

[97] Some states require creditors to pay interest to consumers for escrowed funds but most states do not have such a requirement.

or that would require a creditor to offer an escrow, but permit consumers to opt-out of escrows at closing. These alternatives would not provide consumers sufficient protection from the injuries discussed above, as explained in more detail below.

Alternatives to requiring creditors to escrow. Some creditors that currently do not escrow oppose requiring escrows because of the substantial cost to set up new systems and maintain them over time. They suggested that narrower, less costly alternatives would protect consumers adequately. Most of these suggestions involved disclosure, such as: requiring creditors to warn consumers that they will be responsible for property tax and insurance obligations; estimating these obligations on the TILA disclosure based on recent assessments; and prohibiting creditors from advertising monthly payments without including estimated amounts for property taxes and insurance.

The Board does not believe that these disclosures would adequately protect consumers from the injuries discussed above. Because many consumers focus on monthly payment obligations, competition would continue to give originators incentives to downplay tax and insurance obligations when they discuss payment obligations with consumers. A disclosure provided at origination of the estimated property tax and insurance premiums does not assist those consumers who need an escrow to ensure they save for and pay their obligations on time. Moreover, adding a disclosure to the many disclosures consumers already receive would not be sufficient to educate first time homebuyers and homeowners whose previous loans contained escrows who lack any real experience handling their own taxes and insurance. Disclosure does, however, have an important role to play. Under the final rule, an advertisement for closed-end credit secured by a first lien on a principal dwelling that states a monthly payment of principal and interest must prominently disclose that taxes and insurance premiums are not included. *See* § 226.24(f)(3). Moreover, the Board plans to explore revising the TILA disclosures to add an estimate of property tax and insurance premium costs to the disclosed monthly payment.

For similar reasons, merely mandating that creditors offer escrows, but not that they require them, would not sufficiently address the injuries associated with the failure to escrow. Without a widespread requirement to escrow, some creditors could still press a competitive advantage in quoting low monthly payments that do not include amounts for escrows by encouraging consumers to decline the offered escrow. A rule that required creditors merely to offer escrows would impose essentially the same costs on creditors to establish escrow systems as would the requirement to establish escrows, but would not alter the competitive landscape of the subprime market in a way that would make widespread escrowing more likely.

Creditors also suggested that consumers would be adequately protected by the final rule's requirement that creditors consider a consumer's ability to handle tax and insurance obligations in addition to principal and interest payments when originating loans. *See* § 226.34(a)(4). While this requirement will help ensure that consumers can afford their monthly payment obligations, it will not adequately address the injuries discussed above because creditors would continue to have incentives to downplay tax and insurance obligations when they discussed payment obligations with consumers. Nor will the rule requiring consideration of repayment ability sufficiently assist consumers in saving on their own.

Another alternative would be to require escrows only for first time homebuyers or other classes of borrowers (such as previously prime borrowers) less likely to have experience handling tax and insurance obligations on their own. However, limiting the escrow requirement to borrowers who are unaccustomed to paying taxes and insurance on their own would only delay injury, rather than prevent it. For example, if first time homebuyers with higher-priced mortgage loans were required to escrow, those consumers would not gain the experience of paying property taxes and insurance on their own and might reasonably believe that escrows are standard. When those consumers went to refinance their loan, however, creditors could mislead them by quoting payments without amounts for escrow and the consumers might not be able to handle the tax and insurance obligations on their own.

In addition, requiring escrows only for first time homebuyers or other classes of borrowers would not save a creditor the substantial expense of setting up an escrow system unless the creditor declined to extend higher-priced mortgage loans to such borrowers. The Board believes most creditors would not find this option practical over the long term. Moreover, defining the categories of covered borrowers would present practical challenges, require regular adjustment as the market changed, and complicate creditors' compliance.

Several commenters recommended that the requirement to escrow be limited to higher-priced mortgage loans with a combined loan-to-value ratio that exceeds 80 percent. They contended that borrowers with at least 20 percent equity have the option to tap this equity to finance tax and insurance obligations. The suggested exemption could, however, have the unintended consequence of permitting unscrupulous originators to ''strip'' the equity from less experienced borrowers. As described above, homeowners with existing escrow accounts who want to refinance their loans may assume erroneously that payment quotes include escrows when they do not, or they may prefer the security that an escrow would provide if offered.

Cancellation after consummation. The final rule permits, but does not require, creditors to offer consumers an option to cancel their escrows 12 months after consummation of the loan transaction. Based on the operation of escrows in the prime market, the Board anticipates that creditors will likely offer cancellation in exchange for a fee. The Board acknowledges concerns expressed by individual consumers that requiring them to escrow for even a relatively short time will increase their costs. These costs include the opportunity costs of the funds in escrow, particularly if the funds do not earn interest; a fee to cancel after 12 months; costs associated with mistakes or abuses by escrow agents; and the cost of saving for the deposit at consummation of two months or more of escrow payments that RESPA permits a creditor to require. Mindful of these costs, the Board considered requiring only that creditors offer consumers a choice to escrow either on an ''opt in'' or ''opt out'' basis.

As explained above, the Board concluded that a requirement merely to offer the consumer a choice to escrow would not be effective to prevent the injuries associated with the lack of opportunity to escrow. A requirement to offer, not require, escrows would raise creditors' costs but would not eliminate their incentive to quote lower payment amounts without escrows and encourage borrowers to opt-out. Requiring creditors to disclose information about the benefits of escrowing would not adequately address this problem. It is likely that most consumers would reasonably focus their attention more on disclosures about the terms of the credit being offered, such as the monthly payment amount, rather than on information about the benefits of escrowing. An originator engaged in loan flipping might reassure the consumer that if the consumer has any difficulty with the tax and insurance obligations the originator will refinance the loan.

For the foregoing reasons, the Board does not believe that requiring creditors merely to offer escrows with higher-priced mortgage loans, with an opt out or opt in before consummation, would provide consumers sufficient protection. The Board has concluded that requiring creditors to impose escrows on borrowers with higher-priced mortgage loans, with an option to cancel only some time after consummation, would more effectively address the problems created by subprime creditors' failure to offer escrows. This approach imposes costs on creditors that will be passed on, at least in part, to consumers but the Board believes these costs are outweighed by the benefits. Moreover, to the extent that escrows improve loan performance and lead to fewer defaults, the benefits of escrows may reduce the costs associated with establishing and maintaining escrow accounts.

Twelve months mandatory escrow. The final rule sets the mandatory period for escrows at 12 months after loan origination, at which point creditors may allow borrowers to opt out of escrow. Some community groups commented that escrows should be mandatory for a longer period or even the life of the loan. Several groups commented that borrowers should not be allowed to opt out unless they have demonstrated a record of timely payments. Several commenters noted that consumers should be allowed to opt out at loan consummation.

The Board believes that a 12 month period appropriately balances consumer protection with consumer choice. For the reasons already explained, a mandatory period of some length is necessary to ensure that originators will not urge consumers to reduce their monthly payment by choosing not to escrow immediately at, or shortly after, loan consummation. Twelve months appears to be a sufficiently long period to render such efforts ineffectual, and to introduce consumers to the benefits of escrowing, as most consumers will receive bills for taxes and insurance in that period. Moreover, 12 months is a relatively short period compared to the expected life of the average loan, providing consumers an opportunity to handle their own taxes and insurance obligations after the initial escrow requirement expires.

Although fees to cancel escrow accounts are common, a consumer who expects to hold the loan for a long period may find it worthwhile to pay the fee. The final rule neither permits nor prohibits creditors from imposing escrow cancellation fees and instead defers to state law on that issue. Similarly, the rule neither requires nor prohibits payment of interest on escrow accounts since some, but not all, states have chosen to address consumer concerns about losing the opportunity to invest their funds by requiring creditors to pay interest on funds in escrow accounts.

Exemptions for Cooperatives; Partial Exemption for Condominiums

In response to comments and the Board's own analysis, the final rule does not require escrows for property taxes and insurance premiums for first-lien higher-priced mortgage loans secured by shares in a cooperative if the cooperative association pays property tax and insurance premiums. The final rule requires escrows for property taxes for first-lien higher-priced mortgage loans secured by condominium units but exempts from the escrow requirement insurance premiums if the condominium's association maintains and pays for insurance through a master policy.

Cooperatives. The final rule exempts mortgage loans for cooperatives from the escrow requirement if the cooperative pays property tax and insurance premiums, and passes the costs on to individual unit owners based on their pro rata ownership share in the cooperative. A cooperative association typically owns the building, land, and improvements, and each unit owner holds a cooperative share loan based on the appraisal value of the shareholder's unit. Creditors typically require cooperative associations to maintain insurance coverage under a single package policy, commonly called an association master policy, for common elements, including fixtures, service equipment and common personal property. Creditors periodically review an association master policy to ensure adequate coverage.

At loan origination, creditors inform consumers of their monthly cooperative association dues, which include, among other costs, the consumer's pro rata share for insurance and property taxes. When property taxes and insurance premiums are included in the monthly association dues, they are generally not escrowed with the lender. This is because the consumer's payment of the monthly association dues acts in a manner similar to an escrow itself. In this way, the collection of insurance premiums and property tax amounts on a monthly basis by a cooperative association ensures that taxes and insurance are paid when due.

Condominiums. The final rule exempts certain higher-priced mortgage loans secured by condominium units from the requirement to escrow for homeowners insurance where the only insurance policy required by the creditor is the condominium association master policy. No exemption is provided, however, for escrows for property taxes.

Typically, individual condominium units are taxed similarly to single-family homes. Generally, each unit owner pays the property tax for the unit and each unit is assessed its pro rata share of property taxes for common areas. Condominium owners who do not have escrow accounts receive property tax bills directly from the taxing jurisdiction. The final rule requires escrows for property taxes for all higher-priced mortgage loans secured by condominium units, regardless of whether creditors are required to escrow insurance premiums for such loans.

Homeowners insurance for condominiums, on the other hand, can vary based on the condominium association's bylaws and other governing regulations, as well as specific creditor requirements. Generally, the condominium association insures the building and the common area under an association master policy. In some cases, the condominium association does not insure individual units and a separate insurance policy must be written for each individual unit, just as it would be for a single-family home. In other cases, the master policy does cover individual unit owners' fixtures and improvements other than personal property. When the condominium association insures the entire structure, including individual units, the condominium association pays the insurance premium and passes the costs on to the individual unit owner. Much like the cooperative arrangement described above, the consumer's payment of insurance premiums through condominium association dues acts in a manner similar to an escrow account. For this reason, the final rule does not require creditors to escrow insurance premiums for higher-priced mortgage loans secured by condominium units if the only insurance that the creditor requires is an association master policy that insures condominium units.

Manufactured Housing

The final rule requires escrows for all covered loans secured by manufactured housing for which creditors receive applications on or after October 1, 2010 to allow creditors and servicers sufficient time to establish the capacity to escrow. Manufactured housing industry commenters requested that manufactured housing loans be exempted from the escrow requirement. They argued that manufactured housing loans are mostly personal property loans taxed in many local jurisdictions like other personal property, and that creditors and servicers do not require and do not offer escrows on manufactured housing loans.[98] For reasons discussed in more detail below, the final rule does not exempt from the escrow requirement higher-priced mortgage loans secured by a first lien on manufactured housing used as the consumer's principal dwelling. The final rule applies to manufactured housing whether or not state law treats it as personal or real property.[99]

A manufactured home owner typically pays personal property taxes directly to the taxing authority and insurance premiums directly to the insurer. Manufactured housing industry commenters argued that if a taxing jurisdiction does not have an automated personal property tax system, creditors and servicers would have to service escrows on manufactured housing loans manually at prohibitively high cost, especially taking into consideration small loan size and low amount of property taxes for an average manufactured home.

The Board believes, nonetheless, that problems associated with first-lien higher-priced mortgage loans secured by manufactured housing are similar to problems associated with site-built home loans discussed above. Large segments of manufactured housing consumers are low to moderate income families who may not enter the market with full information about the obligations associated with owning manufactured housing. Instead, consumers are likely to rely on the dealer or the manufacturer as their source for information, which can leave consumers vulnerable. Often, consumers obtain financing through the dealer, who ties the financing to the sale of the home. In addition, commissions and yield spread premiums may be paid to dealers for placing consumers in high cost loans.[100]

In addition, manufactured homes are usually concentrated in developments, such as parks, where they represent a large percentage of homes. Where property tax revenues are the main source of funding for local government services, a failure by a significant number of homeowners to pay property taxes could cause a reduction in local government services and an attendant decline in property values.

The Board believes that homeowners of manufactured housing should be afforded the same consumer protections as the owners of site-built homes. Manufactured homes provide much needed affordable housing for millions of Americans who, like owners of site-built homes, risk losing their homes for failure to pay property taxes. Escrows for property taxes and insurance premiums on first-lien, higher-priced mortgage loans secured by manufactured homes that are consumers' principal dwellings are necessary to prevent creditors from understating the cost of homeownership, to inform consumers that their manufactured home is subject to property tax, and to extend an opportunity to consumers to escrow funds each month for payment of property tax and insurance premiums.

State Laws

Several industry commenters asked the Board to clarify in the final rule that the escrow requirement preempts inconsistent state escrow laws. TILA generally preempts only inconsistent state laws. *See* TILA Section 111(a)(1), 15 U.S.C. 1610, § 226.28. Several consumers expressed concern that the regulation would preempt state laws requiring creditors to pay interest on escrow accounts under certain conditions. The final rule does not prevent states from requiring creditors to pay interest on escrowed amounts. *See* comment § 226.35(b)(4)(i).

Effective Date

Several industry representatives commented that the escrow requirement would require major system and infrastructure changes by creditors that do not currently have escrow capabilities. They asked for an extended compliance deadline of 12 to 24 months prior to the effective date of the final rule to allow for necessary escrow systems and procedures to develop. The Board recognizes that creditors and servicers will need some time to develop in-house escrowing capabilities or to outsource escrow servicing to third parties. For that reason, the Board agrees that an extended compliance period is appropriate for most covered loans secured by site-built homes. Therefore, the final rule is effective for first-lien higher-priced mortgage loans for which creditors receive applications on or after April 1, 2010, except for loans secured by manufactured housing. Recognizing that there is a limited infrastructure for escrowing on manufactured housing loans, and that yet additional time is needed for creditors and servicers to comply with the rule, the final rule is effective for all covered loans secured by manufactured housing for which creditors receive applications on or after October 1, 2010.

E. Evasion Through Spurious Open-End Credit—§ 226.35(b)(4)

The exclusion of HELOCs from § 226.35 is discussed in subpart A. above. As noted, the Board recognizes that the exclusion of HELOCs could lead some creditors to attempt to evade the restrictions of § 226.35 by structuring credit as open-end instead of closed-end. Section 226.34(b) addresses this risk as to HOEPA loans by prohibiting creditors from structuring a transaction that does not meet the definition of ''open-end credit'' as a HELOC to evade HOEPA. The Board proposed to extend this rule to higher-priced mortgage loans and is adopting § 226.35(b)(5). Section 226.35(b)(5) prohibits 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 restrictions of § 226.35. The Board is also adding comment 35(b)(5)-1 to provide guidance on how to apply the higher-priced mortgage loan APR trigger in § 226.35(a) to a transaction structured as open-end credit in violation of § 226.35. Comment 35(b)(5)-1 is substantially similar to comment 34(b)-1 which applies to HOEPA loans.

Public Comment

The Board received relatively few comments on the proposed anti-evasion rule. As discussed in subpart A. above, some commenters suggested applying § 226.35 to HELOCs, which would

[98] Manufactured housing creditors are currently required by law to escrow for property taxes in Texas. Prior to passing state legislation requiring escrows on manufactured housing, Texas legislators observed that many manufactured housing owners were unaware of, and unable to pay, their property tax. *See* Tex. SB 521, 78th Tex. Leg., 2003, effective June 18, 2003; bill analysis available through the Texas Senate Research Center at *http://www.legis.state.tx.us/tlodocs/78R/analysis/pdf/SB00521I.pdf*.

[99] Regulation Z currently defines a dwelling to include manufactured housing. *See* § 226.2(a)(19). Official staff commentary § 226.2(a)(19) states that mobile homes, boats and trailers are dwellings if they are in fact used as residences; § 226.2(b) clarifies that the definition of ''dwelling'' includes any residential structure, whether or not it is real property under state law; §§ 226.15(a)(1)–5 and 226.23(a)(1)–3 make clear that a dwelling may include structures that are considered personal property under state laws (*e.g.*, mobile home, trailer or houseboat) and draws no distinction between personal property loans and real property loans.

[100] *Kevin Jewell, Market Failures Evident in Manufactured Housing* (Jan. 2003), *http://www.consumersunion.org/consumeronline/pastissues/housing/marketfailure.html*.

eliminate the need for an anti-evasion provision. By contrast, some creditors who supported the exclusion of HELOCs from § 226.35 noted that the presence of the anti-evasion provision would address concerns about HELOCs being used to evade the rules in § 226.35. However, a few creditors expressed concern that the anti-evasion proposal was too vague. One commenter stated that loans that do not meet the definition of open-end credit would be subject to the closed-end rules with or without the anti-evasion provision, and this commenter stated that therefore the anti-evasion provision was unnecessary and might cause confusion.

The Board also requested 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. Commenters did not express support for this alternative, and a few explicitly opposed it.

The Final Rule

The Board is adopting the anti-evasion provision as proposed. The rule is not meant to add new substantive requirements for open-end credit, but rather to ensure that creditors do not structure a loan which does not meet the definition of open-end credit as a HELOC to evade the requirements of § 226.35. The Board recognizes that consumers may prefer HELOCs to closed-end home equity loans because of the added flexibility HELOCs provide them. The Board does not intend to limit consumers' ability to choose between these two ways of structuring home equity credit. The anti-evasion provision is intended to reach cases where creditors have structured loans as open-end ''revolving'' credit, even if the features and terms or other circumstances demonstrate that the creditor had no reasonable expectation of repeat transactions under a reusable line of credit. Although the practice violates TILA, the new rule will subject creditors to HOEPA's stricter remedies if the credit carries an APR that exceeds § 226.35's APR trigger for higher-priced mortgage loans.

The Board is also adding comment 35(b)(5)-1 to provide guidance on how to apply the higher-priced mortgage loan APR trigger in § 226.35(a) to a transaction structured as open-end credit in violation of § 226.35. Specifically, the comment provides guidance on how to determine the ''amount financed'' and the ''principal loan amount'' needed to determine the loan's APR. The comment provides that the amount of credit that would have been extended if the loan had been documented as a closed-end loan is a factual determination to be made in each case.

X. Final Rules for Mortgage Loans—§ 226.36

Section 226.35, discussed above, applies certain new protections to higher-priced mortgage loans and HOEPA loans. In contrast, § 226.36 applies other new protections to mortgage loans generally, though only if secured by the consumer's principal dwelling. The final rule prohibits: (1) Creditors or mortgage brokers from coercing, influencing, or otherwise encouraging an appraiser to provide a misstated appraisal and (2) servicers from engaging in unfair fee and billing practices. The final rule neither adopts the proposal to require servicers to deliver a fee schedule to consumers upon request, nor the proposal to prohibit creditors from paying a mortgage broker more than the consumer had agreed in advance that the broker would receive. As with proposed § 226.35, § 226.36 does not apply to HELOCs.

The Board finds that the prohibitions in the final rule are necessary to prevent practices that the Board finds to be unfair, deceptive, associated with abusive lending practices, or 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.A above. The Board also believes that the final rules will enhance consumers' informed use of credit. *See* TILA Sections 105(a), 102(a).

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

The Board proposed to prohibit a creditor from paying a mortgage broker in connection with a covered transaction more than the consumer agreed in writing, in advance, that the broker would receive. The broker would also disclose that the consumer ultimately would bear the cost of the entire compensation even if the creditor paid any part of it directly; and that a creditor's payment to a broker could influence the broker to offer the consumer loan terms or products that would not be in the consumer's interest or the most favorable the consumer could obtain.[101] Proposed commentary provided model language for the agreement and disclosures. The Board stated that it would test this language with consumers before determining how it would proceed on the proposal.

The Board tested the proposal with several dozen one-on-one interviews with a diverse group of consumers. On the basis of this testing and other information, the Board is withdrawing the proposal. The Board will continue to explore available options to address unfair acts or practices associated with originator compensation arrangements such as yield spread premiums. The Board is particularly concerned with arrangements that cause the incentives of originators to conflict with those of consumers, where the incentives are not transparent to consumers who rely on the originators for advice. As the Board comprehensively reviews Regulation Z, it will continue to consider whether disclosure or other approaches could be effective to address this problem.

Public Comment

The Board received over 4700 comments on the proposal. Mortgage brokers, their federal and state trade associations, the Federal Trade Commission, and several consumer groups argued that applying the proposed disclosures to mortgage brokers but not to creditors' employees who originate mortgages (''loan officers'') would reduce competition in the market and harm consumers. They contended that disclosing a broker's compensation would cause consumers to believe, erroneously, that a loan arranged by a broker would cost more than a loan originated by a loan officer. These commenters stated that many brokers would unfairly be forced out of business, and consumers would pay higher prices, receive poorer service, or have fewer options. The FTC, citing its published report of consumer testing of mortgage broker compensation disclosures, contended that focusing consumers' attention on the amount of the broker's compensation could confuse consumers and, under some circumstances, lead them to select a more expensive loan.

Mortgage brokers and some creditors expressed concerns that the proposed rule would not be practicable in cases where creditors forward applications to other creditors and where brokers decide to fund an application using a warehouse line of credit.

Consumer advocates, members of Congress, the FDIC, and others stated

[101] Creditors could demonstrate compliance with the proposed rule 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, and one where a creditor can demonstrate that its payments to a mortgage broker are not determined by reference to the transaction's interest rate.

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

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

Commenters generally did not believe the proposed alternatives for compliance (where a state law provides substantially equivalent protections or where a creditor can show that the compensation amount is not tied to the interest rate) were feasible. Creditors and mortgage brokers stated that both alternatives were vague and would be little used. Consumer advocates believed the alternatives would likely create loopholes in the rule.

Comments on specific issues are discussed in more detail below as appropriate.

Discussion

The proposal was intended to limit the potential for unfairness, deception, and abuse in yield spread premiums while preserving the ability of consumers to cover their payments to brokers through rate increases. Creditor payments to brokers based on the interest rate give brokers an incentive to provide consumers loans with higher interest rates. Many consumers are not aware of this incentive and may rely on the broker as a trusted advisor to help them navigate the complexities of the mortgage application process.

The proposal sought to reduce the incentive of the broker to increase a consumer's rate and increase the consumer's leverage to negotiate with the broker. Under the proposal, creditor payments to brokers would be conditioned on a broker's advance commitment to a specified compensation amount. The proposal would require the agreement to be entered into before an application was submitted by a consumer or prior to the payment of any fee, whichever occurred earlier. Requiring an agreement before a fee or application would help ensure the compensation was set as independently as possible of loan's rate and other terms, and that the consumer would not feel obligated to proceed with the transaction. The Board also anticipated that the proposal would increase transparency and improve competition in the market for brokerage services, which could lower the price of these services, improve the quality of those services, or both.

Reasons for withdrawal. Based on the Board's analysis of the comments, consumer testing, and other information, the Board is withdrawing the proposal. The Board is concerned that the proposed agreement and disclosures would confuse consumers and undermine their decision-making rather than improve it. The risks of consumer confusion arise from two sources. First, an institution can act as either creditor or broker depending on the transaction; as explained below, this could render the proposed disclosures inaccurate and misleading in some, possibly many, cases of both broker and creditor originations. Second, consumers who participated in one-on-one interviews about the proposed agreement and disclosures often concluded, erroneously, that brokers are categorically more expensive than creditors or that brokers would serve their best interests notwithstanding the conflict resulting from the relationship between interest rates and brokers' compensation.

Dual roles. Mortgage brokers and creditors noted that creditors and brokers often play one of two roles. That is, an institution that is ordinarily a creditor and originates loans in its name may determine that it cannot approve an application based on its own underwriting criteria and present it to another creditor for consideration. This practice is known as ''brokering out.'' The institution brokering out an application would be a mortgage broker under the proposed rule; to receive compensation from the creditor, it would have to execute the required agreement and provide the required disclosures.

The proposal requires a broker to enter an agreement and give disclosures before the consumer submits an application, but an institution often may not know whether it will be a broker or a creditor for that consumer until it receives and evaluates the application. An institution that is ordinarily a creditor but sometimes a broker would have to enter into the agreement and give the disclosures for all consumers that seek to apply. In many cases, however, the institution will originate the loan as a creditor and not switch to being a broker. In these cases, the agreement and disclosures, which describe the institution as a broker and state its compensation as if it were brokering the transaction, would likely mislead and confuse the consumer. This problem also arises, if less frequently, when an institution that ordinarily brokers instead acts as creditor on occasion. On those occasions, the disclosures also would likely be misleading and confusing.

The source of the problem is the proposed requirement that the agreement be signed and disclosures given before the consumer has applied for a loan or paid a fee. The Board considered permitting post-application execution and disclosure by institutions that perform dual roles. The proposed timing, however, was intended to ensure that a consumer would be apprised of the broker's compensation and understand the broker's role before becoming, or feeling, committed to working with the broker. Accordingly, the Board concluded that providing this information later in the loan transaction would seriously undermine the proposal's objective of empowering the consumer to shop and negotiate.

Consumer testing. Consumer testing also suggested that at least some aspects of the proposal could confuse and mislead consumers. After publishing the proposal, a Board contractor, Macro International, Inc. (''Macro''), conducted in-depth one-on-one interviews with a diverse group of several dozen consumers who recently had obtained a mortgage loan.[102] Macro developed and tested a form in which the broker would agree to a specified total compensation and disclose (i) that any part of the compensation paid by the creditor would cost the consumer a higher interest rate, and (ii) that creditor payments to brokers based on the rate create a conflict of interest between mortgage brokers and consumers. Throughout the testing, revisions were made to the form in an effort to improve comprehension. The testing revealed two difficulties with the forms tested.

First, the form's statements that the consumer would pay the broker through a higher rate and that the broker had a conflict of interest confused many participants. Many participants stated, upon reading the disclosure, that if they agreed to pay the compensation the broker was asking, then the broker

[102] For more details on the consumer testing, see Macro's report, *Consumer Testing of Mortgage Broker Disclosures*, (July 10, 2008), available at *http://www.federalreserve.gov*.

would be obliged to find them the lowest interest rate and best terms available. Many participants reached this conclusion despite the clear statement in the form tested that brokers can increase their compensation by increasing the interest rate.

Second, many first-round participants stated or implied after reading the form that working through a broker would cost them more than working directly with a lender, which is not necessarily true. A new provision was added to the disclosure stating that lenders' employees are paid the same types of rate-based commissions as brokers and have the same conflict of interest. Many participants, however, continued to voice a belief that brokered loans must cost more than direct loans.

The results of testing indicate that consumers did not sufficiently understand some major aspects of the proposed disclosures. On the one hand, the disclosures could cause consumers to believe that mortgage brokers have obligations to them that the law does not actually impose. In consumer testing, this belief seemingly resulted from the disclosure of the fact that the consumer would pay the broker a commission, and it persisted notwithstanding the accompanying disclosure of the conflict of interest resulting from the rate-commission relationship. On the other hand, the disclosures could cause consumers to believe that retail loans are categorically less costly than brokered loans. Notwithstanding an explicit statement in the tested forms that commissions based on interest rates also are paid to loan officers, many participants voiced the belief that loan officers' commissions would be lower than brokers' commissions. They offered different reasons for this conclusion, including for example that the lender and not the consumer would pay the loan officer's commission.

Despite the difficulties with the disclosures observed in consumer testing, there were also some successes. For instance, consumers generally appeared to understand the language describing the potential conflict of interest, as noted above, even though it often was ignored because of seemingly conflicting information. In addition, language intended to convey to consumers the importance of shopping on their own behalf in the mortgage market appeared to be successful. These more encouraging results suggest that further development of a disclosure approach to creditor payments to mortgage originators, through additional consumer testing, still may have merit.

Conclusion. The Board considered whether it could resolve the problems described above by applying the proposal to the retail channel. The Board concluded, however, that substantial additional testing and analysis would be required to determine whether such an approach would be effective. Therefore, the Board is withdrawing the proposal. The Board will continue to explore available options to address potential unfairness associated with originator compensation arrangements such as yield spread premiums. As the Board comprehensively reviews Regulation Z, it will continue to consider whether disclosures or other approaches could effectively remedy this potential unfairness without imposing unintended consequences.

Definition of Mortgage Broker

In connection with the proposal relating to mortgage broker compensation and the proposal prohibiting coercion of appraisers, the Board proposed to define ''mortgage broker'' 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. 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. Commenters generally did not comment on the proposed definition.

Defining ''mortgage broker'' is still necessary, notwithstanding the Board's withdrawal of the proposed regulation of creditor payments to mortgage brokers, as mortgage brokers are subject to the prohibitions on coercion of appraisers, discussed below. The Board is adopting the definition of mortgage broker with a minor change to clarify that the term ''mortgage broker'' does not include a person who arranges, negotiates, or otherwise obtains an extension of credit for him or herself.

B. Coercion of Appraisers—§ 226.36(b)

The Board proposed to prohibit creditors and mortgage brokers and their affiliates from coercing, influencing, or otherwise encouraging appraisers to misstate or misrepresent the value of a consumer's principal dwelling. The Board also proposed to prohibit a creditor from extending credit when it knows or has reason to know, at or before loan consummation, that an appraiser has been encouraged by the creditor, a mortgage broker, or an affiliate of either, to misstate or misrepresent the value of a consumer's principal dwelling, unless the creditor acts with reasonable diligence to determine that the appraisal was accurate or extends credit based on a separate appraisal untainted by coercion. The Board is adopting the rule substantially as proposed. The Board has revised some of the proposed examples of conduct that violates the rule and conduct that does not violate the rule and has added commentary about when a misstatement of a dwelling's value is material.

Public Comment

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

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

Many commenters discussed appraisal-related agreements that Fannie Mae and Freddie Mac have entered into with the Attorney General of New York and the Office of Federal Housing Enterprise Oversight (GSE Appraisal Agreements), which incorporated a

Home Valuation Code of Conduct. These commenters urged the Board to coordinate with the parties to the GSE Appraisal Agreements to promote consistency in the standards that apply to the residential appraisal process.

The comments are discussed in greater detail below.

Discussion

The Board finds that it is an unfair practice for creditors or mortgage brokers to coerce, influence, or otherwise encourage an appraiser to misstate the value of a consumer's principal dwelling. Accordingly, the Board is adopting the rule substantially as proposed.

Substantial injury. Encouraging an appraiser to overstate or understate the value of a consumer's dwelling causes consumers substantial injury. An inflated appraisal may cause consumers to purchase a home they otherwise would not have purchased or to pay more for a home than they otherwise would have paid. An inflated appraisal also may lead consumers to believe that they have more home equity than in fact they do, and to 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 his or her ability to refinance and therefore may take on a riskier loan. A consumer also may take out more cash with a refinance or home equity loan than he or she would have had an appraisal not been inflated. Appraiser coercion thus distorts, rather than enhances, competition. Though perhaps less common than overstated appraisals, understated appraisals can cause consumers to be denied access to credit for which they qualified.

Inflated or understated appraisals of homes concentrated in a neighborhood may affect appraisals of neighboring homes, because appraisers factor into a property valuation the value of comparable properties. For the same reason, understated appraisals may affect appraisals of neighboring properties. Therefore, inflating or deflating appraised value can harm consumers other than those who are party to the transaction with the misstated appraisal.

Injury not reasonably avoidable. Consumers who are party to a consumer credit transaction cannot prevent creditors or mortgage brokers from influencing appraisers to misstate or misrepresent a dwelling's value. Creditors and mortgage brokers directly or indirectly select and contract with the appraisers that value a dwelling for a consumer credit transaction. Consumers will not necessarily be aware that a creditor or mortgage broker is pressuring an appraiser to misstate or misrepresent the value of the principal dwelling they offer as collateral for a loan. Furthermore, consumers who own property near a dwelling securing a consumer credit transaction but are not parties to the transaction are not in a position to know that a creditor or mortgage broker is coercing an appraiser to misstate a dwelling's value. Consumers thus cannot reasonably avoid injuries that result from creditors' or mortgage brokers' coercing, influencing, or encouraging an appraiser to misstate or misrepresent the value of a consumer's principal dwelling.

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

For the foregoing reasons, the Board finds that it is an unfair practice for a creditor or mortgage broker to coerce, influence, or otherwise encourage an appraiser to misstate the value of a consumer's principal dwelling. As discussed in part V.A above, the Board has broad authority under TILA Section 129(l)(2) to adopt regulations that prohibit, in connection with mortgage loans, acts or practices that the Board finds to be unfair or deceptive. 15 U.S.C. 1639(l)(2). Therefore, the Board may adopt regulations prohibiting unfair or deceptive practices by mortgage brokers who are not creditors and unfair or deceptive practices that are ancillary to the origination process, when such practices are ''in connection with mortgage loans.'' Because appraisals play an important role in a creditor's decision to extend mortgage credit as well as the terms of such credit, the Board believes that it fits well within the Board's authority under Section 129(l)(2) to prohibit creditors and mortgage brokers from coercing, influencing, or otherwise encouraging an appraiser to misstate the value of a consumer's principal dwelling and creditors from extending credit based on an appraisal when they know that prohibited conduct has occurred. Therefore, the Board issues the final rule prohibiting such acts under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2).

The Final Rule

The Board requested comment on the potential costs and benefits of its proposed appraiser coercion regulation. Some securitization trade associations and financial institutions stated that creditors obtain appraisals for their own benefit, to determine whether to extend credit and the terms of credit extended. The Board recognizes that, because appraisals provide evidence of the collateral's sufficiency to avoid losses if a borrower defaults on a loan, creditors have a disincentive to coerce appraisers to misstate value. However, loan originators may believe that they stand to benefit from coercing an appraiser to misstate value, for example, if their compensation depends more on volume of loans originated than on loan performance. Despite the disincentives cited by some commenters, there is evidence that coercion of appraisers is not uncommon, and may even be widespread.[103]

A few large banks and a financial services trade association suggested that the Board prohibit mortgage brokers from ordering appraisals, as the GSE Appraisal Agreements do. The Board declines to determine that any particular procedure for ordering an appraisal necessarily promotes false reporting of value. As discussed above, the Board finds that coercion of appraisers by creditors or by mortgage brokers is an unfair practice. Therefore, the final rule prohibits actions by creditors and mortgage brokers that are aimed at pressuring appraisers to misstate the value of a consumer's principal dwelling.

In addition, some commenters stated that the Board's rule would be redundant given the existence of USPAP. USPAP, however, establishes uniform rules regarding preparation of appraisals and addresses the conduct of appraisers, not the conduct of creditors or mortgage brokers. The federal financial institution regulatory agencies have issued to the institutions they supervise regulations and guidance that set forth standards for the policies and procedures institutions should implement to enable appraisers to exercise independent judgment when

[103] For example, the October Research Corporation's 2007 National Appraisal Survey (released in Dec. 2006) found that appraisers reported being pressured to restate, adjust, or change reported property values by mortgage brokers (71 percent), real estate agents (56 percent), consumers (35 percent), lenders (33 percent), and appraisal management companies (25 percent).

valuing a property.[104] For example, these regulations prohibit staff and fee appraisers from having any direct or indirect interest, financial or otherwise, in a subject property; fee appraisers also may not have any such interest in the subject transaction.[105] Unlike the Board's rule, however, these federal regulations do not apply to all institutions. Moreover, these federal rules are part of an overarching framework of regulation and supervision of federally insured depository institutions and are not necessarily appropriate for application to independent mortgage companies and mortgage brokers.

Some state legislatures have prohibited coercion of appraisers or enacted general laws against mortgage fraud that may be used to combat appraiser coercion.[106] Not every state, however, has passed laws equivalent to the final rule. Prohibiting creditors and mortgage brokers from pressuring appraisers to misstate or misrepresent the value of a consumer's principal dwelling provides enforcement agencies in every state with a specific legal basis for an action alleging appraiser coercion. Though states are able to take enforcement action against certain institutions that are believed to engage in appraisal abuses,[107] some state laws are preempted as to other creditors. The final rule, adopted under HOEPA, applies equally to all creditors.

In response to the Board's request for comment about the proposed rule's provisions, commenters addressed three main topics: (1) The terms used to describe prohibited conduct; (2) the specific examples of conduct that is prohibited and conduct that is not prohibited; and (3) the proscription on extending credit where a creditor knows about prohibited conduct.

Prohibited conduct. Some commenters recommended that the Board replace the phrase ''coerce, influence, or otherwise encourage'' with ''coerce, bribe, or extort.'' These commenters stated that the words ''influence'' and ''encourage'' are vague and subjective, whereas the words ''bribe'' and ''extort'' would provide bright-line standards for compliance. Like the proposed rule, the final rule prohibits a creditor or mortgage broker from coercing, influencing, or otherwise encouraging an appraiser to misstate the value of a dwelling. The final rule does not limit prohibited conduct to bribery or extortion. Creditors and mortgage brokers may act in ways that would not constitute bribery or extortion but that nevertheless improperly influence an appraiser's valuation of a dwelling. These actions can visit the same harm on consumers as do bribery or extortion, and thus they are prohibited by the final rule. The Board believes that commenters' concerns about the clarity of the terms used in the final rule can be addressed through the examples of conduct that is prohibited and conduct that is not prohibited discussed below.

Examples of conduct prohibited and conduct not prohibited. The proposal offered several examples of conduct that would violate the rule and conduct that would not violate the rule. The Board is adopting the proposed examples of prohibited conduct and adding two new examples of prohibited conduct. The Board also is adopting all but one of the proposed examples of conduct that is not prohibited.

Some commenters requested that additional actions be listed as examples that violate the rule, such as:

- Excluding an appraiser from a list of ''approved'' appraisers because the appraiser had valued properties at an amount that had jeopardized or prevented the consummation of loan transactions.
- Telling an appraiser a minimum acceptable appraised value.
- Providing an appraiser with the price stated in a contract of sale.
- Suggesting that an appraiser consider additional properties as comparable to the subject property, after an appraiser has submitted an appraisal report.

Final § 226.36(b)(1) prohibits conduct that coerces, influences, or encourages an appraiser to misstate or misrepresent the value of a consumer's principal dwelling, and the list of examples the section provides is illustrative and not exhaustive. The Board believes that it is not necessary or possible to list all conceivable ways in which creditors or mortgage brokers could pressure appraisers to misstate a principal dwelling's value. However, the Board has added two examples to enhance the list in § 226.36(b)(1). The final rule does not limit the ability of a creditor or broker to terminate a relationship with an appraiser for legitimate reasons.

Examples of prohibited conduct. The Board is adopting the proposed examples of prohibited conduct and adding two examples. The first added example is a creditor's or broker's exclusion of an appraiser from consideration for future engagement due to the appraiser's failure to report a value that meets or exceeds a minimum threshold. This example is adapted from a statement in the supplementary information to the proposed rule. 73 FR 1701. The second added example is telling an appraiser a minimum reported value of a consumer's principal dwelling that is needed to approve the loan. This example is consistent with the position of the Appraisal Standards Board (ASB), which develops, interprets and amends USPAP, that assignments should not be contingent on the reporting of a predetermined opinion of value.[108]

The Board is not adopting other examples of prohibited conduct suggested by commenters. Some commenters urged the Board to prohibit a creditor or mortgage broker from omitting or removing an appraiser's name from a list of approved appraisers, where the appraiser has not valued a property at the desired amount. The Board believes such conduct is encompassed in the examples provided in § 226.36(b)(1)(i)(B) and (C).

Some commenters also requested that the Board add, as an example of a violation, a creditor's or mortgage broker's provision to an appraiser of the contract of sale for the principal dwelling. The Board is not adopting the example. USPAP Standard Rule 1–5 requires an appraiser to analyze all agreements of sale for a subject property, and Standard Rule 2–2 requires disclosure of information contained in such agreements or an explanation of why such information is unobtainable or irrelevant.

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[104] *See, e.g.*, 12 CFR part 208 subpart E and app. C, and 12 CFR part 225 subpart G (Board); 12 CFR part 34, subparts C and D (Office of the Comptroller of the Currency (OCC)); 12 CFR part 323 and 12 CFR part 365 (FDIC); 12 CFR part 564, 12 CFR 560.100, and 12 CFR 560.101 (Office of Thrift Supervision (OTS)); and 12 CFR 722.5 (National Credit Union Administration (NCUA)). Applicable federal guidance the Board, OCC, FDIC, OTS, and NCUA have issued includes Independent Appraisal and Evaluation Functions, dated October 28, 2003, and Interagency Appraisal and Evaluation Guidelines, dated October 27, 1994.

[105] 12 CFR 225.65 (Board); 12 CFR 34.45 (OCC); 12 CFR 323.5 (FDIC); 12 CFR 564.5 (OTS); and 12 CFR 722.5 (NCUA).

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

[107] For example, in 2006, 49 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. *See, e.g., Iowa ex rel Miller* v. *Ameriquest Mortgage Co.*, No. 05771 EQCE–053090 (Iowa D. Ct. 2006) (Pls. Pet. 5). To settle the complaints, the Ameriquest Parties agreed to abide by policies designed to ensure appraiser independence and accurate valuations.

[108] *See, e.g.*, ASB Advisory Opinion No. 19, Unacceptable Assignment Conditions in Real Property Appraisal Assignments.

Examples of conduct that is not prohibited. The final rule adopts the proposed examples of prohibited conduct with one change. The Board is not adopting proposed § 226.36(b)(1)(ii)(F), which would have provided that the rule would not be violated when a creditor or mortgage broker terminates a relationship with an appraiser for violations of applicable federal or state law or breaches of ethical or professional standards. Some commenters noted that there are other legitimate reasons for terminating a relationship with an appraiser, and they requested that the Board include these as examples of conduct that is not prohibited so that the provision would not be read as implicitly prohibiting them. The Board believes that it is not feasible to list all of the legitimate reasons a creditor or broker might terminate a relationship with an appraiser. Accordingly, the Board is not adopting proposed § 226.36(b)(1)(ii)(F).

Some commenters suggested that the Board delete, from the examples of conduct that is not prohibited, asking an appraiser to consider additional information about a consumer's principal dwelling or about comparable properties. Although in some cases a post-report request that an appraiser consider additional information may be a subtle form of pressure to change a reported value, in other cases such a request could reflect a legitimate desire to improve an appraisal report. Furthermore, federal interagency guidance directs institutions to return deficient reports to appraisers for correction and to replace unreliable appraisals or evaluations prior to the final credit decision.[109] Therefore, the Board is not deleting, from the examples of conduct that is not prohibited, asking an appraiser to consider additional information about a consumer's principal dwelling or about comparable properties. However, § 226.36(b) prohibits creditors and mortgage brokers from making such requests in order to coerce, influence, or otherwise encourage an appraiser to misstate or misrepresent the value of a dwelling.

Extension of credit. As proposed, § 226.36(b)(2) provided that a creditor is prohibited from extending credit if the creditor knows or has reason to know, at or before loan consummation, of a violation of § 226.36(b)(1) (for example, by an employee of the creditor or a mortgage broker), unless the creditor acted with reasonable diligence to determine that the appraisal does not materially misstate the value of the consumer's principal dwelling. The proposed comment to § 226.36(b)(2) stated that a creditor is deemed to have acted with reasonable diligence if the creditor extends credit based on an appraisal other than the one subject to the restriction.

The Board is adopting the text of § 226.36(b)(2) and the associated commentary substantially as proposed. Some financial institutions and financial institution trade associations stated that the phrase ''reason to know'' is vague and that creditors should be held liable for violations only if they extend credit when they had actual knowledge that a violation of § 226.36(b)(1) exists. The final rule prohibits ''a creditor who knows, at or before loan consummation, of a violation of § 226.36(b)(1) in connection with an appraisal'' from extending credit based on that appraisal, unless the creditor acts with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of the consumer's principal dwelling. Although final § 226.36(b)(2) does not include the phrase ''reason to know'' included in the proposed rule, the final rule's knowledge standard is not intended to permit willful disregard of violations of § 226.36(b)(1). The Board also is adopting new commentary regarding how to determine whether a misstatement of value is material.

Many banks asked for guidance on how to determine whether an appraisal ''materially'' misstates a dwelling's value. In response to these comments, the Board is adopting a new comment to § 226.36(b)(2) that provides that a misrepresentation or misstatement of a dwelling's value is not material if it does not affect the credit decision or the terms on which credit is extended. The Board notes that existing appraisal regulations and guidance may direct creditors to take certain steps in the event the creditor knows about problems with an appraisal. For example, the Interagency Appraisal and Evaluation Guidelines dated Oct. 28, 1994 direct institutions to return deficient reports to appraisers and persons performing evaluations for correction and to replace unreliable appraisals or evaluations prior to making a final credit decision. These guidelines further state that changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified state-licensed or -certified appraiser in accordance with Standard III of USPAP.

The final rule does not dictate specific due diligence procedures for creditors to follow when they suspect a violation of § 226.36(b)(2), however. In addition, the Board does not intend for § 226.36(b)(2) to create grounds for voiding loan agreements where violations are found. That is, if a creditor knows of a violation of § 226.36(b)(1), and nevertheless extends credit in violation of § 226(b)(2), while the creditor will have violated § 226.36(b)(2), this violation does not necessarily void the consumer's loan agreement with the creditor. Whether the loan agreement is void is a matter determined by State or other applicable law.

C. Servicing Abuses—§ 226.36(c)

The Board proposed to prohibit certain practices of servicers of closed-end consumer credit transactions secured by a consumer's principal dwelling. Proposed § 226.36(d) provided that no servicer shall: (1) Fail to credit a consumer's periodic payment as of the date received; (2) impose a late fee or delinquency charge where the late fee or delinquency charge is due only to a consumer's failure to include in a current payment a late fee or delinquency charge imposed on earlier payments; (3) fail to provide a current schedule of servicing fees and charges within a reasonable time of request; or (4) fail to provide an accurate payoff statement within a reasonable time of request. The final rule, redesignated as § 226.36(c), adopts the proposals regarding prompt crediting, fee pyramiding, and payoff statements, and modifies and clarifies the accompanying commentary. The Board is not adopting the fee schedule proposal, for the reasons discussed below.

Public Comment

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

Prompt crediting. Commenters generally favored, or did not oppose, the prompt crediting rule. In particular, consumer advocacy groups, federal and state regulators and officials, and others supported the rule. However, some industry commenters and others

[109] *See* Interagency Appraisal and Evaluation Guidelines, SR 94–55 (FIS) (Oct. 24, 1994) at 9.

requested clarification on certain implementation details. Commenters also disagreed about whether and how to address partial payments.

Fee pyramiding. Commenters generally supported prohibiting late fee pyramiding. Several industry commenters argued, however, that a new rule would be unnecessary because servicers are subject to a prohibition on pyramiding under other regulations.

Fee schedule. Most commenters opposed the fee schedule proposal. One consumer advocate group criticized the disclosure's utility where consumers cannot shop for and select servicers. Other consumer advocates urged the Board to adopt alternative measures they argued would be more effective to combat fee abuses. Industry commenters also objected to the proposal as impracticable and unnecessarily burdensome. Most industry commenters strongly opposed disclosure of third party fees, particularly because third party fees can vary greatly and may be indeterminable in advance.

Payoff statements. Consumer advocates strongly supported the proposal to require provision of payoff statements within a reasonable time. The proposed commentary stated that it would be reasonable under normal market conditions to provide statements within three business days of receipt of a consumer's request. Community banks stated that three business days would typically be adequate. However, large financial institutions and their trade associations urged the Board to adopt a longer time period in the commentary. These commenters also requested other clarifications. The comments are discussed in more detail throughout this section, as applicable.

Discussion

As discussed in the preamble to the proposed rule, the Board shares concerns about abusive servicing practices. Consumer advocates raised abusive mortgage servicer practices as part of the Board's 2006 and 2007 hearings as well as in recent congressional hearings.[110] Servicer abuses have also received increasing attention both in academia and the press.[111] In particular, consumer advocates have raised concerns that some servicers may be charging consumers unwarranted or excessive fees (such as late fees and other ''service'' fees) and may be improperly submitting negative credit reports, in the normal course of mortgage servicing as well as in foreclosures. Some of these abusive fees, they contend, result from servicers' failure to promptly credit consumers' accounts, or when servicers pyramid late fees. In addition to anecdotal evidence of significant consumer complaints about servicing practices, abusive practices have been cited in a variety of court cases.[112] In 2003, the FTC announced a $40 million settlement with a large mortgage servicer and its affiliates to address allegations of abusive behavior.[113]

Consumer advocates have also raised concerns that consumers are sometimes unaware of fees charged, or unable to understand the basis upon which fees are charged. This may occur because servicers often do not disclose precise fees in advance; some consumers are not provided any other notice of fees (such as a monthly statement or other after-the-fact notice); and when consumers are provided a statement or other fee notice, fees may not be itemized or detailed. For example, in a number of bankruptcy cases, servicers have improperly assessed post-petition fees without notifying either the consumer or the court.[114] Similarly, because payoff statements lack transparency (in that they do not provide detailed accounting information) and because consumers are often unaware of the exact amount owed, some servicers may assess inaccurate or false fees on the payoff statement.[115]

Substantial injury. Consumers subject to the servicer practices described above suffer substantial injury. For example, one state attorney general and several consumer advocates stated that failure to properly credit payments is one of the most common problems consumers have with servicers. Servicers that do not timely credit, or that misapply, payments cause the consumer to incur late fees where none should be assessed.[116] Even where the first late fee is properly assessed, servicers may apply future payments to the late fee first. Doing so results in future payments being deemed late even if they are, in fact, paid in full within the required time period, thus permitting the servicer to charge additional late fees—a practice commonly referred to as ''pyramiding'' of late fees. These practices can cause the account to appear to be in default, and thus can give rise to charging excessive or unwarranted fees to consumers, who may not even be aware of the default or fees if they do not receive statements. Once consumers are in default, these practices can make it difficult for consumers to catch up on payments. These practices also may improperly trigger negative credit reports, which can cause consumers to be denied other credit or pay more for such credit, and

[110] *See, e.g.,* Comment letter of the National Consumer Law Center to Docket No. OP–1253 (Aug. 15, 2006) at 11; *Legislative Proposals on Reforming Mortgage Practices, Hearing Before the H. Comm. On Fin. Servs.,* 110th Cong. 74 (2007) (Testimony of John Taylor, National Community Reinvestment Coalition).

[111] *See, e.g.,* Paula Fitzgerald Bone, *Toward a General Model of Consumer Empowerment and Welfare in Financial Markets with an Application to Mortgage Servicers,* 42 Journal of Consumer Affairs 165 (Summer 2008); Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims,* University of Iowa Legal Study Research Paper No. 07–29 (Nov. 2007); Kevin McCoy, *Hitting Home: Homeowners Fight for their Mortgage Rights,* USA Today (June 25, 2008), available at *http://www.usatoday.com/money/industries/banking/2008-06-25-mortgage-services-countrywide-lawsuit_N.htm*; Mara Der Hovanesian, *The ''Foreclosure Factories'' Vise,* BusinessWeek.com (Dec. 25, 2006), available at *http://www.businessweek.com/magazine/content/06_52/b4015147.htm?chan=search.*

[112] *See, e.g., Workman* v. *GMAC Mortg. LLC (In re Workman),* 2007 Bankr. LEXIS 3887 (Bankr. D. S.C. Nov. 21, 2007) (servicer held in civil contempt for, among other things, failure to promptly credit payments made before discharge from bankruptcy and charging of unauthorized late and attorneys fees); *Islam* v. *Option One Mortgage Corp.,* 432 F. Supp. 2d 181 (D. Mass 2006) (servicer allegedly continued to report borrower delinquent even after receiving the full payoff amount for the loan); *In Re Gorshstein,* 285 B.R. 118 (S.D.N.Y. 2002) (servicer sanctioned for falsely certifying that borrowers were delinquent); *Rawlings* v. *Dovenmuehle Mortgage Inc.,* 64 F. Supp. 2d 1156 (M.D. Ala. 1999) (servicer failed for over 7 months to correct account error despite borrowers' twice sending copies of canceled checks evidencing payments, resulting in unwarranted late and other fees); *Ronemus* v. *FTB Mortgage Servs.,* 201 B.R. 458 (1996) (among other abuses, servicer failed to promptly credit payments and instead paid them into a ''suspense'' account, resulting in unwarranted late fees and unnecessary and improper accrual of interest on the note).

[113] 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).

[114] *See, e.g., Jones* v. *Wells Fargo (In re Jones),* 366 B.R. 584 (E.D. La 2007) (''In this Court's experience, few, if any, lenders make the adjustments necessary to properly account for a reorganized debt repayment plan. As a result, it is common to see late charges, fees, and other expenses assessed to a debtor's loan as a result of post-petition accounting mistakes made by lenders.''). *See also Payne* v. *Mortg. Elec. Reg. Sys. (In re Payne),* 2008 Bankr. LEXIS 1340 (Bankr. Kan. May 6, 2008); *Sanchez* v. *Ameriquest (In re Sanchez),* 372 B.R. 289 (S.D. Tx. 2007); *Harris* v. *First Union Mortg. Corp. (In re Harris),* 2002 Bankr. LEXIS 771 (Bankr. D. Ala. 2002); *In Re Tate,* 253 B.R. 653.

[115] *See, e.g., Maxwell* v. *Fairbanks Capital Corp. (In re Maxwell),* 281 B.R. 101, 114 (D. Mass 2002) (servicer ''repeatedly fabricated the amount of the Debtor's obligation to it out of thin air'').

[116] *See, e.g. Holland* v. *GMAC Mortg. Corp.,* 2006 U.S. Dist. LEXIS 25723 (D. Kan. 2006) (servicer's misapplication of borrower's payment to the wrong account resulted in improper late fees and negative credit reports, despite borrower's proof of canceled checks); *In re Payne*, 2008 Bankr. LEXIS at *30 (servicer's failure to properly and timely account for payments and failure to distinguish between pre-petition and post-petition payments caused its accounting system and payment history to improperly show borrowers as delinquent in their payments).

require consumers to engage in time-consuming credit report correction efforts.

In addition, a servicer's failure to provide accurate payoff statements in a timely fashion can cause substantial injury to consumers. One state attorney general commented that its office often receives complaints about unreasonable delays in the provision of payoff statements. Consumers may want to refinance a loan to obtain a lower interest rate or to avoid default or foreclosure, but may be impeded from doing so due to inaccurate or untimely payoff statements. These consumers thus incur additional costs and may be subject to financial problems or even foreclosure. In addition to the injuries caused by delayed payoff statements, consumers are injured by inaccurate payoff statements. As described above, some servicers assess inaccurate or false fees on the payoff statement without the consumer's knowledge. Even when the consumer requests clarification, a servicer may provide an invalid accounting of fees or charges.[117] Or, a servicer may provide the payoff statement too late in the refinancing process for the consumer to obtain clarification without risking losing his or her new loan commitment.[118]

Injury not reasonably avoidable. The injuries caused by servicer abuses are not reasonably avoidable because market competition is not adequate to prevent abusive practices, particularly when mortgages are securitized and servicing rights are sold. Historically, under the mortgage loan process, a lender would often act as both originator and collector—that is, it would service its own loans. Although some creditors sold servicing rights, they remained vested in the customer service experience in part due to reputation concerns and in part because payment streams continued to flow directly to them. However, with rise of the ''originate to distribute'' model discussed in part II.B above, the original creditor has become removed from future direct involvement in a consumer's loan, and thus has less incentive and ability to detect or deter servicing abuses or respond to consumer complaints about servicing abuses. When loans are securitized, servicers contract directly with investors to service the loan, and consumers are not a party to the servicing contract.

Today, separate servicing companies play a key role: they are chiefly responsible for account maintenance, including collecting payments, remitting amounts due to investors, handling interest rate adjustments on variable rate loans, and managing delinquencies and foreclosures. Servicers also act as the primary point of contact for consumers after origination, because in most cases the original creditor has securitized and sold the loan shortly after origination. 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 consumers must pay.

Investors are principally concerned with maximizing returns on the mortgage loans and are generally indifferent to the fees the servicer charges the consumer so long as the fees do not reduce the investor's return (*e.g.*, by prompting an unwarranted foreclosure). Consumers are not able to choose their servicers. Consumers also are not able to change servicers without refinancing, which is a time-consuming, expensive undertaking. Moreover, if interest rates are rising, refinancing may only be possible if the consumer accepts a loan with a higher interest rate. After refinancing, consumers may find their loans assigned back to the same servicer as before, or to another servicer engaging in the same practices. As a result, servicers do not have to compete in any direct sense for consumers. Thus, there may not be sufficient market pressure on servicers to ensure competitive practices.[119]

Injury not outweighed by countervailing benefits to consumers or to competition. The injuries described above also are not outweighed by any countervailing benefits to consumers or competition. Commenters did not cite, and the Board is not aware of, any benefit to consumers from delayed crediting of payments, pyramided fees, or delayed issuance of payoff statements.

For these reasons, the Board finds the acts and practices prohibited under § 226.36(c) for closed-end consumer credit transactions secured by a consumer's principal dwelling to be unfair. As described in part V.A above, TILA Section 129(l)(2) authorizes protections against unfair practices ''in connection with mortgage loans'' that the Board finds to be unfair or deceptive. 15 U.S.C. 1639(l)(2). Therefore, the Board may take action against unfair or deceptive practices by non-creditors and against unfair or deceptive practices outside of the origination process, when such practices are ''in connection with mortgage loans.'' 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 as such is ''in connection with mortgage loans.'' Accordingly, the final rule prohibits certain unfair or deceptive servicing practices under Section 129(l)(2), 15 U.S.C. 1639(l)(2).

The Final Rule

Section 226.36(c) prohibits three servicing practices. First, the rule prohibits a servicer from failing to credit a payment to a consumer's account as of the date received. Second, the rule prohibits ''pyramiding'' of late fees by prohibiting a servicer from imposing a late fee on a consumer for making a payment that constitutes the full amount due and is timely, but for a previously assessed late fee. Third, the rule prohibits 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 in full, often referred to as a payoff statement. Under § 226.36(c)(3), the term ''servicer'' and ''servicing'' are given the same meanings as provided in Regulation X, 24 CFR 3500.2. As described in more detail below, the Board is not adopting the proposed rule that would prohibit a servicer from failing to provide to a consumer, within a reasonable time after receiving a request, a schedule of all fees and charges it imposes in connection with mortgage loans it services.

The Board recognizes that servicers will incur additional costs to alter their systems to comply with some aspects of the final rule. For example, in some instances some servicers may incur costs in investing in systems to produce payoff statements within a shorter period of time than their current technology affords. As a result, some servicers will, directly or indirectly, pass those costs on to consumers. The Board believes, however, that these costs to consumers are outweighed by

[117] *See, e.g., In re Maxwell,* 281 B.R. 101, 114 (D. Mass 2002).

[118] *See, e.g., In re Jones,* 366 B.R. at 587–588 (consumer in bankruptcy forced to remit improper sums demanded on payoff statement or lose loan commitment from new lender. ''Although Debtor questioned the amounts [servicer] alleged were due, he was unable to obtain an accounting from [servicer] explaining its calculations or any other substantiation for the payoff.'').

[119] In one survey, J.D. Power found that consumers whose loans have been sold have customer satisfaction scores 32 points lower than those who have remained with the loan originator. J.D. Power and Associates Reports: USAA Ranks Highest in Customer Satisfaction with Primary Mortgage Servicing. Press Release (July 19, 2006), available at *http://www.jdpower.com/corporate/news/releases/pdf/2006117.pdf.*

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the consumer benefits provided by the rules as adopted.

Prompt Crediting

The Board proposed §§ 226.36(d)(1)(i) and 226.36(d)(2) to prohibit a servicer from failing to credit payments as of the date received. The proposed prompt crediting rule and accompanying commentary are substantially similar to the existing provisions requiring prompt crediting of payment on open-end transactions in § 226.10. The final rule adopts, as §§ 226.36(c)(1)(i) and 226.36(c)(2), the rule substantially as proposed, but with revisions to the proposed commentary to address the questions of partial payments and payment cut-off times. Commentary has also been added or modified in response to commenters' concerns.

Commenters generally favored, or did not oppose, the prompt crediting rule. In particular, consumer advocacy groups, federal and state regulators and officials, and others supported the rule. One state attorney general and several consumer advocacy groups stated that failure to properly credit payments is one of the most common servicing problems they see consumers face. However, as described in more detail below, some industry commenters and others requested clarification on certain implementation details. Commenters also generally disagreed on whether and how to address partial payments.

Method and timing of payments. Section 226.36(c)(1)(i) requires 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 any charge to the consumer or in the reporting of negative information to a consumer reporting agency, or except as provided in § 226.36(c)(2). Many industry commenters, as well as the GSEs requested clarifications on the timing and method of crediting payments, and the final staff commentary has been revised accordingly.

For example, final comment 36(c)(1)(i)–1 makes clear that the rule does not require a servicer to physically enter the payment on the date received, but requires only that it be credited as of the date received. The proposed comment explained that a servicer does not violate the rule if it receives a payment on or before its due date and enters the payment on its books or in its system after the due date if 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. Because consumers are often afforded a grace period before a late fee accrues, the Board has revised the comment to reference grace periods. The final comment thus states that a servicer that receives a payment on or before the due date (or within any grace period), and does not enter the payment on its books or in its system until after the payment's due date (or expiration of any grace period) does not violate the rule 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. If a payment is received after the due date and any grace period, § 226.36(c)(1)(i) does not prohibit the assessment of late charges or reporting negative information to a consumer reporting agency.

Some industry commenters were concerned that the rule would affect their monthly interest accrual accounting systems. Many closed-end mortgage loan agreements require calculation of interest based on an amortization schedule where payments are deemed credited as of the due date, whether the payment was actually received prior to the scheduled due date or within any grace period. Thus, making the scheduled payment early does not decrease the amount of interest the consumer owes, nor does making the scheduled payment after the due date (but within a grace period) increase the interest the consumer owes. According to these commenters, this so-called ''monthly interest accrual amortization method'' provides certainty to consumers (about payments due) and to investors (about expected yields). The final rule is not intended to prohibit or alter use of this method, so long as the servicer recognizes on its books or in its system that payments have been timely made for purposes of determining late fees or triggering negative credit reporting.

The final rule also adopts proposed comment 36(d)(2)–1, redesignated as 36(c)(2)–1, which states that the servicer may specify in writing reasonable requirements for making payments. One commenter expressed concern that late fees or negative credit reports may be triggered when a timely payment requires extensive research, and the creditor may inadvertently violate § 226.36(c)(1)(i). Such research might be required, for example, when a check does not include the account number for the mortgage loan and is written by someone other than the consumer. However, in this scenario, the check would typically constitute a payment that does not conform to the servicer's reasonable payment requirements. If a payment is non-conforming, and the servicer nonetheless accepts the payment, then § 226.36(c)(2) provides that the servicer must credit the account within five days of receipt. If the servicer chooses not to accept the non-conforming payment, it would not violate the rule by returning the check.

Comment 36(c)(2)–1 provides examples of reasonable payment requirements. Although the list of examples is non-exclusive, at the request of several commenters, payment coupons have been added to the list of examples because they can assist servicers in expediting the crediting process to consumers' benefit.

The Board sought comment on whether it should provide 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. Commenters generally supported including safe harbors; accordingly, new comment 32(c)(2)–2 provides that it would be reasonable to require a cut-off time of 5 p.m. for receipt of a mailed check at the location specified by the creditor for receipt of such check.

Partial payments. The Board sought comment on whether (and if so, how) partial payments should be addressed in the prompt crediting rule. Consumer advocate and industry commenters disagreed on whether partial payments should be credited, if the consumer's payment covers at least the principal and interest due but not amounts due for escrows or late or other service fees. Consumer groups argued that servicers should be required to credit partial payments under the rule, when the payment would cover at least the principal and interest due. They expressed concern that servicers routinely place such partial payments into suspense accounts, triggering the accrual of late fees and other default fees. On the other hand, most industry commenters urged the Board not to require crediting of partial payments, because doing so would contradict the structure of uniform loan documents, would violate servicing agreements, would be contrary to monthly interest accrual accounting methods, and would require extensive systems and accounting changes. They also argued that crediting partial payments could cause the consumer's loan balance to increase. After crediting the partial payment, the servicer would add the remaining payment owed to the principal balance; thus, the principal balance would be greater than the amount scheduled (and the interest calculated on that larger principal balance that would be due would be greater than the scheduled interest). As a result, subsequent regularly scheduled payments would no longer cover the actual outstanding principal and interest due.

New comment 36(c)(1)(i)–2 makes clear that whether a partial payment must be credited depends on the contract between the parties. Specifically, the new comment states that payments should be credited based on the legal obligation between the creditor and consumer. The comment also states that the legal obligation is determined by applicable state law or other law. Thus, if under the terms of the legal obligations governing the loan, the required monthly payment includes principal, interest, and escrow, then consistent with those terms, servicers would not be required to credit payments that include only principal and interest payments. Concerns about partial payments may be addressed in part by the fee pyramiding rule, discussed below, which prohibits servicers from charging late fees if a payment due is short solely by the amount of a previously assessed late fee.

Pyramiding Late Fees

The Board proposed to adopt a parallel approach to the existing prohibition on late fee pyramiding contained 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(c)(1)(ii) would have prohibited servicers from imposing any late fee or delinquency charge on the consumer in connection with a payment, when the consumer's payment was timely and made in full but for any previously assessed late fees. The proposed commentary provided that the prohibition should be construed consistently with the credit practices rule. The final rule adopts the proposal and accompanying staff commentary.

Commenters generally supported prohibiting fee pyramiding. Several commenters argued, however, that a new rule would be unnecessary because servicers are subject to a regulation prohibiting fee pyramiding, whether they are banks (12 CFR 227.15), thrifts (12 CFR 535.4), credit unions (12 CFR 706.4) or other institutions (16 CFR 444.4). However, the Board believes that adopting a fee pyramiding prohibition under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), would extend greater protections to consumers than currently provided by regulation. While fee pyramiding is impermissible for all entities under either the Board, OTS, or FTC rules, state officials are not granted authority under the FTC Act to bring enforcement actions against institutions. By bringing the fee pyramiding rule under TILA Section 129(l)(2), state attorneys general would be able to enforce the rule through TILA, where currently they may be limited to enforcing the rule solely through state statutes (which statutes may not be uniform). Accordingly, the anti-pyramiding rule adopted today would provide state attorneys general an additional means of enforcement against servicers, thus providing an additional consumer protection against an unfair practice.

Schedule of Fees and Charges

Proposed 226.36(d)(1)(iii) would have required 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 each fee may be imposed. The proposal would have required a fee schedule that is specific both as to the amount and type of each charge, to prevent servicers from disguising fees by lumping them together or giving them generic names. The proposal also would have required the disclosure of third party fees assessed on consumers by servicers. The rule was intended to bring transparency to the market, to enhance consumer understanding of servicer charges, and to make it more difficult for unscrupulous servicers to camouflage or inflate fees. The Board sought comment on the effectiveness of this approach, and solicited suggestions on alternative methods to achieve the same objective. Given servicers' potential difficulty in identifying the specific amount of third party charges prior to imposition of such charges, the Board also sought comment on whether the benefit of increasing the transparency of third party fees would outweigh the costs associated with a servicer's uncertainty as to such fees.

Most commenters opposed the fee schedule proposal. One consumer advocate group argued that the disclosure would not help because consumers cannot shop for and select servicers. Other consumer advocates urged the Board to adopt alternative measures they argued would be more effective to prevent servicer abuses. Industry commenters also objected to the proposal as impracticable and unnecessarily burdensome. Some stated that they currently provide limited fee schedules upon request, but that they would incur a substantial time and cost burden to reprint schedules or add addenda when fees change. Many industry commenters strongly opposed disclosure of third party fees. These commenters argued that fees can vary greatly by geography (inter- and intra-state) and over the life of the loan, and are not within the servicer's control, particularly when the consumer is in default. Moreover, they stated, some charges relating to foreclosure or other legal actions cannot be determined in advance. For example, newspaper publication costs will vary depending on the newspaper and length of the notice required; third party service providers may charge varying prices based on the cost of labor, materials, and scope of work required.[120] Industry commenters maintained that servicers would pass on to consumers the costs of the increased burden and risk incurred. At a minimum, they argued, the fee schedule should be limited to standard or common fees, such as nonsufficient fund fees or duplicate statement fees.

The Board has considered the concerns raised by commenters and has concluded that the transparency benefit of the schedule does not sufficiently offset the burdens of producing such a schedule. Thus, the Board is not adopting proposed § 226.36(d)(1)(iii). First, the transparency benefit is limited. It is not clear that consumers would request fee schedules sufficiently in advance of being charged any fees so as to provide consumers the benefit of the notice intended by the proposed rule. In addition, any schedules provided to consumers may be out of date by the time the consumer is assessed fees. Many third party fees would also be impractical to specify. Even if third party fees are simply listed as ''actual charge'' or ''market price,'' the fee schedules may be too long—possibly dozens of pages— and detailed to be meaningful or useful to consumers. The Board considered limiting fee schedules to the servicer's own standard fees. However, while such schedules might assist consumers who are current, they would be of limited utility to delinquent consumers, who are often subject to substantial third party fees. For the foregoing reasons, the Board is not adopting proposed § 226.36(d)(1)(iii).

The Board solicited suggestions on alternative methods to address servicer charges and fees. Commenters urged the Board to consider a variety of alternatives to combat abusive servicing

[120] *See, e.g.*, Vikas Bajaj, *Contractors Are Kept Busy Maintaining Abandoned Homes,* N.Y. Times (May 26, 2008), available at *http://www.nytimes.com/2008/05/27/business/27home.html?_r=1&scp=1&sq=florida+foreclosure&st=nyt&oref=slogin.*

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practices, including prohibiting servicers from imposing fees unless the fee is authorized by law, agreed to in the note, and bona fide and reasonable; prohibiting servicers from misstating the amounts consumers owe; and requiring servicers to provide monthly statements to consumers to permit consumers to monitor charges. The Board continues to have concerns about transparency and abuse of servicer fees. The Board will continue to evaluate the issue, and may consider whether to propose additional rules in this area in connection with its comprehensive review of Regulation Z's closed-end mortgage disclosure rules.

Loan Payoff Statements

Proposed § 226.36(d)(1)(iv) would have prohibited 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. The proposed commentary stated that under normal market conditions, three business days would be a reasonable time to provide the payoff statements; however, a longer time might be reasonable when the market is experiencing an unusually high volume of refinancing requests.

Consumer advocates strongly supported the proposed rule, and most community banks stated that three business days would be adequate for production of payoff statements. However, large financial institutions and their trade associations urged the Board to adopt a longer time period in the commentary than three business days. Large financial institutions and their trade associations also requested clarification on requests from third parties, citing privacy concerns. Further, they urged the Board to refine the rule to provide that statements should be accurate when issued, because events could occur after issuance that would make the payoff statement inaccurate.

The Board is adopting the rule substantially as proposed, renumbered as § 226.36(c)(1)(iii), with clarifications and changes to the commentary. The Board has revised the accompanying staff commentary to provide that five business days would normally be a reasonable time to provide the statements under most circumstances, and to make several other clarifications in response to commenters' concerns.

Servicers' delays in providing payoff statements can impede consumers from refinancing existing loans or otherwise clearing title and increase transaction costs. Promptly delivered payoff statements also help consumers to monitor inflated payoff claims. Thus, the Board is adopting a rule requiring servicers to provide an accurate payoff statement within a reasonable time after receiving a request.

As noted above, the proposed commentary stated that under normal market conditions, three business days would be a reasonable time to provide the payoff statements. Large financial institutions and their trade associations encouraged the Board to extend the three business day time frame to anywhere from five business days to fifteen calendar days to provide servicers enough time to compile the necessary payoff information. While the Board notes that the commentary's time frame is a safe harbor and not a requirement, the Board is extending the time frame from three to five business days to address commenters' concerns.

Several industry commenters also requested special time periods for homes in foreclosure or loss mitigation. Some argued that emergency circumstances (such as imminent foreclosure) require swifter servicer action; on the contrary, others argued that such circumstances are inherently complicated and require additional servicer time and effort. However, the Board believes five business days should provide sufficient time to handle most payoff requests, including most requests where the loan is delinquent, in bankruptcy, or the servicer has incurred an escrow advance. As discussed below, there may be circumstances under which a longer time period is reasonable; the response time would simply not fall under the five business day safe harbor.

The commentary retains the proposal that the time frame might be longer in some instances. The example has been revised, however, from when ''the market'' is experiencing an unusually high volume of refinancing requests to ''the servicer.'' A particular servicer's experience may not correspond perfectly with general market conditions. The example is intended to recognize that more time may be reasonable where a servicer is experiencing temporary constraints on its ability to respond to payoff requests. The example is not intended, however, to enable servicers to take an unreasonable amount of time to provide payoff statements if it is due to a failure to devote adequate staffing to handling requests. The Board believes that the revised commentary balances servicers' operational needs with consumers' interests in promptly obtaining a payoff statement.

Under the proposed rule, the servicer would be required to respond to the request of a person acting on behalf of the consumer. Thus, for example, a creditor with which a consumer is refinancing may request a payoff statement. Others who act on the consumer's behalf, such as a non-profit homeownership counselor, also may wish to obtain a payoff statement for the consumer. Some industry commenters expressed concern about the privacy implications of such a requirement, and requested that the Board permit additional time to confirm the consumer's permission prior to releasing account information. To address these concerns, the Board has revised the commentary to state that the servicer may first take reasonable measures to verify the identity of persons purporting to act on behalf of the consumer and to obtain the consumer's authorization to release information to any such persons before the ''reasonable time'' frame begins to run.

Industry commenters also requested that, as in the prompt crediting rule, servicers be permitted to specify reasonable requirements to ensure payoff requests may be promptly processed. The Board believes clear procedures for consumer requests for loan payoff statements will benefit consumers, as these procedures will expedite processing of a consumer's request. Therefore, the Board is adding new commentary 226.36(c)(1)(iii)–3 to clarify that the servicer may specify reasonable requirements for making payoff requests, such as requiring requests to be in writing and directed to a specific address, e-mail address or fax number specified by the servicer, or orally to a specified telephone number, or any other reasonable requirement or method. If the consumer does not follow these requirements, a longer time frame for responding to the request would be reasonable.

Finally, industry commenters requested clarification that the statement must be accurate when issued. They maintained that events occurring after issuance of the statement cause a statement to become inaccurate, such as when a consumer's previous payment is returned for insufficient funds after the servicer has issued the loan payoff statement. The Board is adding new comment 226.36(c)(1)(iii)–4 to explain that payoff statements must be accurate when issued. The payoff statement amount should reflect all payments due and all fees and charges incurred as of the date of issuance. However, the Board recognizes that events occurring after issuance and outside the servicer's control, such as a returned check and nonsufficient funds fee, or an escrow advance, may cause the payoff statement to become inaccurate. If the statement was accurate when it was issued, subsequent events that change the payoff amount do not result in a violation of the rule.

D. Coverage—§ 226.36(d)

The Board proposed to exclude HELOCs from § 226.36(d) because 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, and HELOC originations are concentrated in the banking and thrift industries, where the federal banking agencies can use supervisory authorities to protect borrowers. As described in more detail in part IX.E above, the proposed exclusion of HELOCs drew criticism from several consumer and civil rights groups but strong support from industry commenters. For the reasons discussed in part VIII.H above, the Board is adopting the exclusion as proposed, renumbered as § 226.36(d).

XI. Advertising

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

The final rule is substantially similar to the proposed rule and adopts, with some modifications, each of the proposed changes discussed above. The most significant changes are: Modifying when an advertisement is required to disclose certain information about tax implications; using the term ''promotional'' rather than ''introductory'' to describe certain open-end credit rates or payments applicable for a period less than the term of the loan and removing the requirement that advertisements with promotional rates or payments state the word ''introductory;'' excluding radio and television advertisements for home-equity plans from the requirements regarding promotional rates or payments; allowing advertisements for closed-end credit to state that payments do not include mortgage insurance premiums rather than requiring advertisements to state the highest and lowest payment amounts; and removing the prohibition on the use of the term ''financial advisor'' by a for-profit mortgage broker or mortgage lender.

Public Comment

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

A. Advertising Rules for Open-End Home-Equity Plans—§ 226.16

Overview

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

First, as proposed, the Board is revising 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 clarify how the clear and conspicuous standard applies to advertisements of home-equity plans with promotional rates or payments, and to Internet, television, and oral advertisements of home-equity plans. The rule also allows 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(e) and 72 FR 32948, 33064 (June 14, 2007).

Second, the Board is amending the regulation and commentary to ensure that advertisements adequately disclose not only promotional plan terms, but also the rates and payments that will apply over the term of the plan. The changes are modeled after proposed amendments to the advertising rules for open-end plans that are not home-secured. *See* 73 FR 28866, 28892 (May 19, 2008) and 72 FR 32948, 33064 (June 14, 2007).

The Board is also implementing 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* Public Law 109–8, 119 Stat. 23. Other technical and conforming changes are also being made.

The Board proposed to prohibit certain acts or practices connected with advertisements for closed-end mortgage credit under TILA section 129(l)(2) and sought comment on whether it should extend any or all of the prohibitions contained in proposed § 226.24(i) to home-equity plans, or whether there were other acts or practices associated with advertisements for home-equity plans that should be prohibited. The final rule does not apply the prohibitions contained in § 226.24(i) to home-equity plans for the reasons discussed below in connection with the final rule for closed-end mortgage credit advertisements. *See* discussion of § 226.24(i) below.

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 –2.

Authority

The Board is exercising the following authorities in promulgating final rules. 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 147, be disclosed in a clear and conspicuous manner. 15 U.S.C. 1632. TILA Section 147 also requires that information, including any other information required by regulation by the Board, be clearly and conspicuously set forth in such form and manner as the Board may by regulation require. 15 U.S.C. 1665b.

Discussion

Clear and conspicuous standard. The Board is adopting as proposed new comments 16–2 to –5 to clarify how the clear and conspicuous standard applies to advertisements for home-equity plans.

Comment 16–1 explains that advertisements for open-end credit are subject to a clear and conspicuous standard set forth in § 226.5(a)(1). The Board is not prescribing specific rules regarding the format of advertisements. However, new comment 16–2 elaborates on the requirement that certain disclosures about promotional 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 promotional rates or payments are advertised and the disclosure requirements of new § 226.16(d)(6) apply. The disclosures are 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 promotional rate or payment are deemed to meet this requirement if they appear in the same type size as the trigger terms. A more detailed discussion of the requirements for promotional rates or payments is found below.

The equal prominence and close proximity requirements of § 226.16(d)(6) apply to all visual text advertisements except for television advertisments. However, comment 16–2 states that electronic advertisements that disclose promotional rates or payments in a manner that complies with the Board's recently amended rule for electronic advertisements under § 226.16(c) are 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.

The Board sought 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 promotional rates or payments in a manner that does not require the consumer to click a link to access the information. The majority of commenters who addressed this issue urged the Board to adopt comment 16–2 as proposed. They noted that many electronic advertisements on the Internet are displayed in small areas, such as in banner advertisements or next to search engine results, and requiring information about the rates or payments that apply for the term of the plan to be in close proximity to the promotional rates or payments would not be practical. These commenters also suggested that Internet users are accustomed to clicking on links in order to find further information. Commenters also expressed concern about the practicality of requiring closely proximate disclosures in electronic advertisements that may be displayed on devices with small screens, such as on Internet-enabled cellular phones or personal digital assistants, that might necessitate scrolling or clicking on links in order to view additional information.

The Board is adopting comment 16–2 as proposed. The Board agrees that requiring disclosures of information about rates or payments that apply for the term of the plan to be in close proximity to promotional rates or payments would not be practical for many electronic advertisements and that the requirements of § 226.16(c) adequately ensure that consumers viewing electronic advertisements have access to important additional information about the terms of the advertised product.

The Board is also adopting as proposed new comments to interpret the clear and conspicuous standards for Internet, television, and oral advertisements of home-equity plans. New comment 16–3 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 § 226.16(d). New comment 16–4 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). The Board believes, however, that this rule can be applied with some flexibility to account for variations in the size of television screens. For example, a lender would not violate the clear and conspicuous standard if the print size used was not legible on a handheld or portable television. New comment 16–5 explains 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 allowing the use of a toll-free telephone number as an alternative to certain disclosures in radio and television advertisements.

Section 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 is adopting as proposed revisions to 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.

As proposed, new comment 16(d)–6 provides 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 comment, the time period during which an index and margin are considered reasonably current depends on the medium in which the advertisement was distributed. For direct mail advertisements, a reasonably current index and margin is one that was in effect within 60 days before mailing. For printed advertisements made available to the general public and for advertisements in electronic form, a reasonably current index and margin is one that was in effect within 30 days before printing, or 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.

Section 226.16(d)(3)–Balloon Payment

Existing § 226.16(d)(3) requires that 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. As proposed, the Board is revising this section to clarify that only statements of 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 is clarifying that the disclosure is triggered when an advertisement contains a statement of any minimum periodic payment amount 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 is clarifying 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.

The final rule, as proposed, incorporates the language from existing comment 16(d)–7 into the text of § 226.16(d)(3) with technical revisions. The comment is 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.

Section 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 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 tax 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 proposed to revise § 226.16(d)(4) and comment 16(d)–3 to implement TILA Section 147(b). The Board's proposal applied the new requirements 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 sought comment on whether the new requirements should instead apply to only advertisements that state or imply that the creditor provides extensions of credit greater than the fair market value of the dwelling. Of the few commenters who addressed this issue, the majority were in favor of the alternative approach because many home-equity plans may, in some circumstances, allow for extensions of credit greater than the fair market value of the dwelling and advertisers would likely include the disclosure in nearly all advertisements.

The final rule differs from the proposed rule and requires that the additional tax implication disclosures be given only when an advertisement states that extensions of credit greater than the fair market value of the dwelling are available. The rule does not apply to advertisements that merely imply that extensions of credit greater than the fair market value of the dwelling may occur. By limiting the required disclosures to only those advertisements that state that extensions of credit greater than the fair market value of the dwelling are available, the Board believes the rule will provide the required disclosures to consumers when they are most likely to be receptive to the information while avoiding overloading consumers with information about the tax consequences of home-equity plans when it is less likely to be meaningful to them.

Comment 16(d)–3 is revised to conform to the final rule and to clarify when an advertisement must give the disclosures required by § 226.16(d)–4 for all home-equity plan advertisements that refer to tax deductibility and when an advertisement must give the new disclosures relating to extensions of credit greater than the fair market value of the consumer's dwelling.

Section 226.16(d)(6)—Promotional Rates and Payments

The Board proposed to add § 226.16(d)(6) to address the advertisement of promotional (termed ''introductory'' in the proposal) rates and payments in advertisements for home-equity plans. The proposed rule provided that if an advertisement for a home-equity plan stated a promotional rate or payment, the advertisement must use the term ''introductory'' or ''intro'' in immediate proximity to each mention of the promotional rate or payment. The proposed rule also provided that such advertisements must disclose the following information in a clear and conspicuous manner with each listing of the promotional rate or payment: The period of time during which the promotional rate or promotional payment will apply; in the case of a promotional rate, any annual percentage rate that will apply under the plan; and, in the case of a promotional payment, the amount and time periods of any payments that will apply under the plan. In variable-rate transactions, payments determined based on application of an index and margin to an assumed balance would be required to be disclosed based on a reasonably current index and margin.

The final rule excludes radio and television advertisements for home-equity plans from the requirements of § 226.16(d)(6). This modification is consistent with the approach the Board proposed, and is adopting, for § 226.24(f) which contains similar requirements for advertisements for closed-end credit that is home-secured. *See* § 226.24(f)(1). As the Board noted in the supplementary information to the proposal for advertisements for home-secured closed-end loans, 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. The Board also sought comment in connection with closed-end home-secured loans on whether these or different standards should be applied to oral advertisements for home-secured loans but commenters did not address this issue.

The final rule also differs from the proposed rule in using the term ''promotional'' rather than ''introductory'' to describe the rates and payments covered by § 226.16(d)(6). The final rule also does not adopt proposed § 226.16(d)(6)(ii) and proposed comment 16(d)–5.ii which required that advertisements with promotional rates or payments state the term ''introductory'' or ''intro'' in immediate proximity to each listing of a promotional rate or payment. Some industry commenters noted that consumers might be confused by the use of the term ''introductory'' in cases where it applied to a promotional rate or payment that was not the initial rate or payment.

The Board received similar comments in response to its earlier proposal for open-end plans that are not home-secured, and the Board subsequently issued a new proposal for those plans that would use the term ''promotional'' rather than ''introductory'' and require that advertisements state the word ''introductory'' only for promotional rates offered in connection with an account opening. 73 FR 28866, 28892 (May 9, 2008). The Board is adopting the term ''promotional'' rather than ''introductory'' in the rule, but the Board is not requiring open-end home-equity plans to state the word ''introductory'' for promotional rates or payments offered in connection with the opening of an account. While the term ''introductory'' is common in other consumer credit contexts, such as credit cards, it may not be as meaningful to consumers in the context of advertisements for home-equity plans and may be confusing to some consumers in that context. The Board believes that the information required to be disclosed under § 226.16(d)(6) is sufficient to inform consumers that advertised promotional terms will not apply for the full term of the plan.

Commenters also expressed confusion about the distinction between promotional rates under § 226.16(d)(6) and discounted and premium rates under § 226.16(d)(2). While some advertised rates may be covered under both § 226.16(d)(2) and § 226.16(d)(6), each rule covers some rates that the other does not. The definition of a promotional rate under § 226.16(d)(6) is not limited to initial rates; a rate that is not based on the index and margin used to make rate adjustments under the plan may be a promotional rate even if it is not the first rate that applies. At the same time, § 226.16(d)(6) applies to a rate that is not based on the index and margin that will be used to make later rate adjustments under the plan only if that rate is less than a reasonably current annual percentage rate that would be in effect under the index and margin used to make rate adjustments. By contrast, § 226.16(d)(2) applies to an initial annual percentage rate that is not based on the index and margin used to make later rate adjustments regardless of whether the later rate would be greater or less than the initial rate.

Section 226.16(d)(6)(i)—Definitions. The Board proposed to define the terms ''introductory rate,'' ''introductory payment,'' and ''introductory period'' in § 226.16(d)(6)(i). The final rule uses the terms ''promotional rate,'' ''promotional payment,'' and ''promotional period'' instead and the definition of ''promotional payment'' is clarified to refer to the minimum payments under a home-equity plan, but the final rule is otherwise as proposed. In a variable-rate plan, the term ''promotional 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 ''promotional payment'' means, in the case of a variable-rate plan, the amount of any minimum payment applicable to a home-equity plan for a promotional period that is not derived from the index and margin that will be used to determine the amount of any other minimum payments under the plan and, given an assumed balance, is less than any other minimum 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 ''promotional payment'' means the amount of any minimum payment applicable to a home-equity plan for a promotional period if that payment is less than the amount of any other payments required under the plan given an assumed balance. The term ''promotional period'' means a period of time, less than the full term of the loan, that the promotional rate or payment may be applicable.

As proposed, comment 16(d)–5.i clarifies how the concepts of promotional rates and promotional payments apply in the context of advertisements for variable-rate plans. Specifically, the 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 promotional rate or promotional 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 a promotional rate or promotional payment.

The revisions generally assume that a single index and margin will be used to make rate or payment adjustments under the plan. The Board sought 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. Commenters stated that multiple indexes and margins generally are not used within the same plan, but requested clarification on how the requirements of § 226.16(d)(6) would apply to advertisements that contain information about rates or payments based on an index and margin available under the plan to certain consumers, such as those with certain credit scores, but where a different margin may be offered to other consumers. The definitions of promotional rate and promotional payment refer to the rates or payments under the advertised plan. If rate adjustments will be based on only one index and margin for each consumer, the fact that the advertised rate or payment may not be available to all borrowers does not make the advertised rate or payment a promotional one. However, an advertisement for open-end credit may state only those terms that actually are or will be arranged or offered by the creditor. *See* 12 CFR 226.16(a).

One banking industry trade group commenter sought an exception from the definition of promotional rate and promotional payment for initial rates that are derived by applying the index and margin used to make rate adjustments under the loan, but calculated in a slightly different manner than will be used to make later rate adjustments. For example, an initial rate may be calculated based on the index in effect as of the closing or lock-in date, rather than another date which will be used to make other rate adjustments under the plan such as the 15th day of the month preceding the anniversary of the closing date. The Board is not adopting an exception from the definition of promotional rate and promotional payment. However, the Board believes that an initial rate in the example described above would still be ''based on'' the index and margin used to make other rate adjustments under the plan and therefore would not be a promotional rate.

Some industry commenters sought an exclusion from the definition of promotional rate and promotional payment for plans that apply different rates or payments to a draw period and to a repayment period. For example, some plans may provide for interest-only payments during a draw period and fully-amortizing payments during a repayment period. Consistent with the requirements for application disclosures under § 226.5b, the Board is not adopting exceptions for plans with draw periods and repayment periods. If an advertisement states a promotional rate or payment offered during a draw period it must provide the required disclosures about the rates or payments that apply for the term of the plan. The Board believes that such information will help consumers understand the full cost of the credit over the term of the plan.

Commenters also sought to exclude advertisements for plans that permit the consumer to repay all or part of the balance during the draw period at a fixed rate, rather than a variable rate, from the promotional rate and payment requirements. These commenters expressed concern that they did not know at the advertising stage whether consumers would choose the fixed-rate conversion option and that disclosing plans that offer the option as though a consumer had chosen it could lead to confusion. Regulation Z already requires fixed-rate conversion options to be disclosed in applications for variable-rate home-equity plans. *See* comment 5b(d)(5)(ii)–2. The Board believes that requiring information about fixed-rate conversion options to be disclosed in advertisements could confuse consumers about a feature that is optional. New comment 16(d)–5.v states that the presence of a fixed-rate conversion option does not, by itself, make a rate (or payment) a promotional one.

Similarly, some industry commenters also sought an exception from the definition of promotional rate and payment for plans with preferred-rate provisions, where the rate will increase upon the occurrence of some event. For example, the consumer may be given a preferred rate for electing to make automated payments but that preferred-rate would end if the consumer later ceases that election. Regulation Z already requires preferred-rate provisions to be disclosed in applications for variable-rate home-equity plans. *See* comment 5b(d)(12)(viii)–1. The Board believes that requiring information about preferred-rate provisions to be disclosed at the advertising stage is less likely to be meaningful to consumers who are usually gathering general rate and payment information about multiple plans and are less likely to focus on disclosures about preferred-rate terms and conditions. New comment 16(d)–5.vi states that the presence of a preferred-rate provision does not, by itself, make a rate (or payment) a promotional one.

Comment 16(d)–5.iv, renumbered but otherwise adopted as proposed, clarifies how the concept of promotional payments applies in the context of advertisements for non-variable-rate plans. Specifically, the 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 minimum payment could increase solely if the consumer made an additional draw does not make the payment a promotional payment. For example, if a minimum payment of $500 results from an assumed $10,000 draw, and the minimum payment would increase to $1,000 if the consumer made an additional $10,000 draw, the payment is not a promotional payment.

Section 226.16(d)(6)(ii)—Stating the promotional period and post-promotional rate or payments. Section 226.16(d)(6)(ii), renumbered and modified to exclude radio and television advertisements, but otherwise adopted as proposed, provides that if an advertisement states a promotional rate or promotional payment, it must also clearly and conspicuously disclose, with equal prominence and in close proximity to the promotional rate or payment, the following, as applicable: The period of time during which the promotional rate or promotional payment will apply; in the case of a promotional rate, any annual percentage rate that will apply under the plan; and, in the case of a promotional 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 must be disclosed based on a reasonably current index and margin.

Proposed comment 16(d)–5.iii provided safe harbors for satisfying the closely proximate or equally prominent requirements of proposed § 226.16(d)(6)(iii). Specifically, the required disclosures would be deemed to be closely proximate to the promotional rate or payment if they were in the same paragraph as the promotional rate or payment. Information disclosed in a footnote would not be deemed to be closely proximate to the promotional rate or payment. Some commenters noted that the safe harbor definition of ''closely proximate'' in this comment (that the required disclosures be in the same paragraph as the promotional rate or payment) differed from the definition of ''closely proximate'' in comment 16–2 (that the required disclosures be immediately next to or directly above or below the promotional rate or payment). The Board is modifying final comment 16(d)–5.ii, as renumbered, to match the definition of ''closely proximate'' in comment 16–2. However, the Board is retaining the part of the safe harbor that disallows the use of footnotes. 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. As proposed, the required disclosures will be deemed equally prominent with the promotional rate or payment if they are in the same type size as the promotional rate or payment.

Comment 16(d)–5.iii 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. The comment has been modified from the proposal, in response to public comment, to add a clarification that the final payment need not be disclosed if it is not greater than two times the amount of any other minimum payments under the plan. Comment 16(d)–6, which is discussed above, provides safe harbor definitions for the phrase ''reasonably current index and margin.''

Section 226.16(d)(6)(iii)—Envelope excluded. Section 226.16(d)(6)(iii), renumbered but otherwise adopted as proposed, provides that the requirements of § 226.16(d)(6)(ii) 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.

Section 226.16(e)—Alternative Disclosures—Television or Radio Advertisements

The Board is adopting § 226.16(e), as renumbered, to allow for alternative disclosures of the information required for home-equity plans under § 226.16(d)(1), where applicable. The supplementary information to the proposal referred to these as alternative disclosures for oral advertisements, but the proposed regulation text did not limit the alternative disclosures to oral advertisements. The proposed regulation text was consistent with the Board's proposal for credit cards and other open-end plans. *See* proposed § 226.16(f) and 72 FR 32948, 33064 (June 14, 2007). The final rule does not limit the alternative disclosures to oral advertisements. The final rule does, however, limit § 226.16(e)'s application to advertisements for home-equity plans and redesignates it from § 226.16(f) to § 226.16(e). These changes are meant to conform the rule to the existing regulation, but the Board notes that its proposal for open-end plans that are not home-secured, if adopted, would expand the rule to allow for alternative disclosures for all advertisements for open-end credit. In addition, § 226.16(e) permits an advertisement to provide either a toll-free telephone number or a telephone number that allows a consumer to reverse the telephone charges when calling for information. The final rule also adds new commentary clarifying the alternative disclosure option. This commentary was included in the Board's earlier proposal for credit cards and other open-end plans, and is substantively the same as the commentary for alternative disclosures for advertisements for closed-end credit under § 226.24(g). *See* 72 FR 32948, 33144 (June 14, 2007), *and* comments 24(g)–1 and 24(g)–2.

The Board's revision follows the general format of the Board's earlier proposal for alternative disclosures for television and radio advertisements. If a triggering term is stated in the advertisement, one option is to state clearly and conspicuously each of the disclosures required by §§ 226.16(b)(1) and (d)(1). Another option is for the advertisement to state clearly and conspicuously the APR applicable to the home-equity plan, and the fact that the rate may be increased after consummation, and provide a 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 proposed to amend the closed-end credit advertising rules in § 226.24 to address advertisements for home-secured loans. The three most significant aspects of the proposal related to strengthening the clear and conspicuous standard for advertising disclosures, regulating the disclosure of rates and payments in advertisements to ensure that low promotional or ''teaser'' rates or payments are not given undue emphasis, and prohibiting certain acts or practices in advertisements as provided under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2).

The final rule is substantially similar to the proposed rule and adopts, with some modifications, each of the proposed changes discussed above. First, the Board is adding 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 is being 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 staff commentary provisions are 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 final rule also adds 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 amending the regulation and commentary to address the advertisement of rates and payments for home-secured loans. The 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 emphasize low, promotional ''teaser'' rates or payments that will apply for a limited period of time. Such advertisements often do not give consumers accurate or balanced information about the costs or terms of the products offered.

The revisions also prohibit advertisements from disclosing an interest rate lower than the rate at which interest is accruing. Instead, the only rates that may 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 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 prohibiting 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 making several changes to clarify certain provisions of the closed-end advertising rules, including the scope of 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* Public Law 109–8, 119 Stat. 23. Technical and conforming changes to the closed-end advertising rules are also made.

Public Comment

As discussed above, the Board received numerous, mostly positive, comments on the proposed revisions. Specific comments requesting modifications or clarifications to the proposed requirements for advertisements for closed-end home-secured credit are discussed below as applicable.

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 charge expressed as an APR. *See* 12 CFR 226.24(c)–(d) (as redesignated from §§ 226.24(b)–(c)) and the staff commentary thereunder.

Authority

The Board is exercising the following authorities in promulgating final rules. 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).

Section 226.24(b)—Clear and Conspicuous Standard

As proposed, the Board is adding a clear and conspicuous standard in § 226.24(b) that applies to all closed-end advertising. This provision supplements, rather than replaces, the clear and conspicuous standard that applies to all closed-end credit disclosures under Subpart C of Regulation Z and that requires all disclosures to 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 promotional rates or payments.

Existing 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 comment is renumbered as comment 24(b)–1 and revised to reference the 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, comment 24(b)–2 elaborates 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 § 226.24(f). Terms required to be disclosed in close proximity to other rate or payment information are 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 are deemed to meet this requirement if they appear in the same type size as other rates or payments. The requirements for disclosing rates or payments are discussed in more detail below.

The equal prominence and close proximity requirements of § 226.24(f) apply to all visual text advertisements except for television 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 § 226.24(e) are deemed to satisfy the clear and conspicuous standard. *See* 72 FR 63462 (Nov. 9, 2007). Under the existing rule for electronic advertisements, 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 takes the consumer directly to the additional information. *See* comment 24(e)–4.

The Board sought comment on whether it should amend the rules for electronic advertisements for home-secured loans to require that 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 on a link to access the information. The Board also solicited comment on the costs and practical limitations, if any, of imposing this close proximity requirement on electronic advertisements. The majority of commenters who addressed this issue urged the Board to adopt comment 24(b)–2 as proposed. They noted that many electronic advertisements on the Internet are displayed in small areas, such as in banner advertisements or next to search engine results, and requiring information about the rates or payments that apply for the term of the loan in close proximity to all other applicable rates or payments would not be practical. These commenters also suggested that Internet users are accustomed to clicking on links in order to find further information. Commenters also expressed concern about the practicality of requiring closely proximate disclosures in electronic advertisements that may be displayed on devices with small screens, such as on Internet-enabled cellular telephones or personal digital assistants, that might necessitate scrolling or clicking on links in order to view additional information.

The Board is adopting comment 24(b)–2 as proposed. The Board agrees that requiring disclosures of information about rates or payments that apply for the term of the loan to be in close proximity to information about all other rates or payments would not be practical for many electronic advertisements, and that the requirements of § 226.24(e) adequately ensure that consumers viewing electronic advertisements have access to important additional information about the terms of the advertised product.

The Board is also adopting as proposed new comments to interpret the clear and conspicuous standards for Internet, television, and oral advertisements of home-secured loans. 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. 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. The Board believes, however, that this rule can be applied with some flexibility to account for variations in the size of television screens. For example, a lender would not violate the clear and conspicuous standard if the print size used was not legible on a handheld or portable television. Comment 24(b)–5 explains 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 must be intelligible to consumers, not that advertisers must ensure that consumers understand the meaning of the disclosures. Section 226.24(g) provides an alternative method of disclosure for television or radio advertisements when triggering terms are stated and is discussed more fully below.

Section 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 must state the rate as an APR. *See* 12 CFR 226.24(c) (as redesignated from § 226.24(b)). 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.

As proposed, the Board is renumbering § 226.24(b) as § 226.24(c), and revising it. The revised rule provides 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 of interest, or any other rates, is no longer permitted in connection with home-secured loans.

Also as proposed, comment 24(b)–2 is 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 is revised to reference § 226.24(f), which contains requirements regarding the disclosure of rates and payments in advertisements for home-secured loans.

Buydowns. As proposed, comment 24(b)–3, which addresses ''buydowns,'' is 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. Previously, this comment provided that the seller or creditor, in the case of a buydown, could 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 also could show the effect of the buydown agreement on the payment schedule for the buydown period. The Board is revising the comment to explain that additional disclosures are required when an advertisement includes information showing the effect of the buydown agreement on the payment schedule. Such advertisements must provide the disclosures required by § 226.24(d)(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(d)(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, and as proposed, the examples of statements about buydowns that an advertisement may make without triggering additional disclosures are being removed.

Effective rates. As proposed, the Board is deleting what was previously comment 24(b)–4. The comment had allowed 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 staff commentary also contained an example of how to disclose the three rates.

The Board proposed to delete this staff commentary 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 commentary was adopted in 1982, the Board noted that the commentary 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.

Some industry commenters suggested that the advertisement of rates lower than the rate at which interest is accruing might provide meaningful information to some consumers.

Specifically, some advertisements for negative amortization loans and option ARMs quote a payment amount that is based on an effective rate. Commenters suggested that if the corresponding effective rate itself was not advertised, consumers might be confused about the rate on which the payment was based. For the reasons stated above, the Board believes that consumers are likely to be confused by advertisements that state a rate lower than the rate at which interest is accruing. The Board is addressing the advertisement of payments for home-secured loans in new § 226.24(f), discussed below, to require that advertisements contain information about the payments that apply for the term of the loan.

Discounted variable-rate transactions. As proposed, comment 24(b)–5 is being 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 is also being revised to explain that additional disclosures are required when an advertisement includes information showing the effect of the discount on the payment schedule. Such advertisements must provide the disclosures required by § 226.24(d)(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(d)(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 are being removed.

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

Required disclosures. As proposed, the Board is renumbering § 226.24(c) as § 226.24(d) and revising it. The rule clarifies 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 revision is consistent with other 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 changes, and as proposed, comment 24(c)(2)–2 is renumbered as comment 24(d)(2)–2 and revised. As proposed, commentary regarding advertisement of loans that have a graduated-payment feature is being removed from comment 24(d)(2)–2.

The Board did not propose to make substantive changes to commentary regarding advertisements for home-secured loans where payments may vary because of the inclusion of mortgage insurance premiums. Under the existing commentary, the advertisement could 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. Some industry commenters noted, however, that advertisers can only estimate the amounts of mortgage insurance premiums at the advertising stage, and that the requirement to show the largest and smallest of the payments that include mortgage insurance premiums may not be meaningful to consumers because consumers' actual payment amounts may vary from the advertised payment amounts. For this reason, the commentary is being revised to no longer require the advertisement to show the amount of the largest and smallest payments reflecting mortgage insurance premiums. Rather, the advertisement may state the number and timing of payments, the fact that the payments do not include amounts for mortgage insurance premiums, and that the actual payment obligation will be higher.

In advertisements for home-secured loans with one series of low monthly payments followed by another series of higher monthly payments, comment 24(d)(2)–2.iii explains 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 must be based on the assumption that the consumer makes the series of lower 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.

As proposed, the revisions to renumbered comment 24(d)(2)–2 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 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.

As proposed, new comment 24(d)(2)–3 is added to address the disclosure of balloon payments as part of the repayment terms. The commentary 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 commentary 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.

As proposed, comments 24(c)(2)–3 and –4 are renumbered as comments 24(d)(2)–4 and –5 without substantive change.

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

The Board is renumbering § 226.24(d) as § 226.24(e) and making technical changes to reflect the renumbering of certain sections of the regulation and commentary, as proposed.

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

The Board proposed 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 promotional ''teaser'' rates or payments, but adequately disclose the rates and payments that the will apply over the term of the loan. The final rule is adopted as proposed, but adds a number of new commentary provisions to clarify the rule in response to public comment.

One banking industry trade group commenter sought an exception from §§ 226.24(f)(2) and (f)(3)(i)(A) for variable-rate loans with initial rates that are derived by applying the index and margin used to make rate adjustments under the loan, but calculated in a slightly different manner than will be used to make later rate adjustments. For example, an initial rate may be calculated based on the index in effect as of the closing or lock-in date, rather than another date which will be used to make other rate adjustments under the plan such as the 15th day of the month preceding the anniversary of the closing date. The Board is not adopting an exception from §§ 226.24(f)(2) and (f)(3)(i)(A). However, the Board believes that an initial rate in the example described above would still be ''based on'' the index and margin used to make other rate adjustments under the plan and therefore it would not, by itself, trigger the required disclosures in § 226.24(f)(2). Likewise, an advertisement need not disclose a separate payment amount under § 226.24(f)(3)(i)(A) for payments that are based on the same index and margin, if even calculated differently.

Commenters also sought to exclude advertisements for variable-rate loans that permit the consumer to convert the loan into a fixed rate loan. These commenters expressed concern that creditors do not know at the advertising stage whether consumers would choose the fixed-rate conversion option and that disclosing loans that offer the option as though a consumer had chosen it could lead to confusion. Regulation Z already requires fixed-rate conversion options be disclosed before consummation. *See* comment 19(b)(2)(vii)–3. The Board believes that requiring information about fixed-rate conversion options be disclosed in advertisements could confuse consumers about a feature that is optional. New comment 24(f)–1.i states that the creditor need not assume that a fixed-rate conversion option, by itself, means that more than one simple annual rate of interest will apply under § 226.24(f)(2) and the payments that would apply if a consumer opted to convert the loan to a fixed rate need not be disclosed as separate payments under § 226.24(f)(3)(i)(A).

Similarly, some industry commenters also sought an exception for loans with preferred-rate provisions, where the rate will increase upon the occurrence of some event. For example, the consumer may be given a preferred rate for electing to make automated payments but that preferred-rate would end if the consumer later ceases that election. Regulation Z already requires preferred-rate provisions be disclosed before consummation. *See* comment 19(b)(2)(vii)–4. The Board believes that requiring information about preferred-rate provisions to be disclosed at the advertising stage is less likely to be meaningful to consumers who are usually gathering general rate and payment information about multiple loans and are less likely to focus on disclosures about preferred-rate terms and conditions. New comment 24(f)–1.ii states that the creditor need not assume a preferred-rate provision, by itself, means that more than one simple annual rate of interest will apply under § 226.24(f)(2) and need not disclose as separate payments under § 226.24(f)(3)(i)(A) the payments that would result upon the occurrence of the event that causes a rate increase under the preferred-rate provision.

Also, comment 24(f)–1.iii excludes loan programs that offer a rate reduction to consumers after the occurrence of a specified event, such as the consumer making a series of on-time payments. Some industry commenters suggested, and the Board agrees, that information about decreases in rates or payments upon the occurrence of a specified event need not be disclosed with equal prominence and in close proximity to information about other rates and payments. The advertisement may disclose only the initial rate or payment and it need not disclose the effect of the rate reduction feature. Alternatively, the advertisement may also disclose the effect of the rate reduction feature, but it would then have to comply with the requirements of § 226.24(f).

Section 226.24(f)(1)—Scope. Section 226.24(f)(1), as proposed, 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. The Board sought comment on whether these or different standards should be applied to oral advertisements for home-secured loans but commenters did not address this issue.

Section 226.24(f)(2)—Disclosure of rates. As proposed, § 226.24(f)(2) addresses the disclosure of rates. Under the 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.

Comment 24(f)–5, renumbered but otherwise as proposed, specifically addresses 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 revisions generally assume that a single index and margin will be used to make rate or payment adjustments under the loan. The Board solicited 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. Commenters stated that multiple indexes and margins are not used within the same loan, but requested clarification on how the requirements of § 226.24(f) apply to advertisements that contain information about rates or payments based on the index and margin available under the loan to certain consumers, such as those with certain credit scores, but where a different margin may be offered to other consumers. Section 226.24(f) applies to advertisements for variable-rate loans if the simple annual rate of interest (or the payment) that applies at consummation is not based on the index and margin used to make subsequent rate (or payment) adjustments over the term of the loan. *See* comment §§ 226.24(f)–5 and 24(f)(3)–2. If a loan's rate or payment adjustments will be based on only one index and margin for each consumer, the fact that the advertised rate or payment may not be available to all consumers does trigger the requirements of § 226.24(f). However, an advertisement for open-end credit may state only those terms that actually are or will be arranged or offered by the creditor. *See* 12 CFR 226.24(a).

Finally, as proposed, the 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 provided safe harbors for compliance with the equal prominence and close proximity standards. Specifically, the required disclosures would be deemed to be closely proximate to the advertised rate or payment if they were in the same paragraph as the advertised rate or payment. Information disclosed in a footnote would not be deemed to be closely proximate to the advertised rate or payment. Some commenters noted that the safe harbor definition of ''closely proximate'' in this comment (that the required disclosures be in the same paragraph as the advertised rate or payment) differed from the definition of ''closely proximate'' in comment 24–2 (that the required disclosures be immediately next to or directly above or below the advertised rate or payment). The Board is renumbering and modifying final comment 24(f)–2 to match the definition of ''closely proximate'' in comment 24–2. However, the Board is retaining the part of the safe harbor that disallows the use of footnotes. 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. As proposed, the required disclosures will be deemed equally prominent with the advertised rate or payment if they are in the same type size as the advertised rate or payment.

Comment 24(f)–3, renumbered but otherwise as proposed, provides a cross-reference to comment 24(b)–2, which provides further guidance on the clear and conspicuous standard in this context.

Section 226.24(f)(3)—Disclosure of payments. New § 226.24(f)(3) addresses the disclosure of payments. As 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 § 226.24(d).

As proposed, comment 24(f)(3)–2 specifically addresses 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.

As discussed above in regard to § 226.24(f)(2), the revisions in § 226.24(f)(3) generally assume that a single index and margin will be used to make rate or payment adjustments under the loan. If a loan's rate or payment adjustments will be based on only one index and margin for each consumer, the fact that the advertised rate or payment may not be available to all consumers does trigger the requirements of § 226.24(f).

The rule adopts the clear and conspicuous standard for the disclosure of payments in advertisements for home-secured loans as proposed. 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, comment 24(f)–2 provides safe harbors for compliance with the equal prominence and close proximity standards. Comment 24(f)–3 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.

Comment 24(f)–4, renumbered but otherwise as proposed, clarifies how the rules on disclosures of rates and payments in advertisements apply to the use of comparisons in advertisements. This commentary covers both rate and payment comparisons, but in practice, comparisons in advertisements usually focus on payments.

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. The commentary has been modified from the proposal, in response to comment, to add a clarification that the final scheduled payment in a fully amortizing loan need not be disclosed if the final scheduled payment is not greater than two times the amount of any other regularly scheduled payment.

Comment 24(f)–6, renumbered but otherwise as proposed, provides safe harbors for what constitutes a ''reasonably current index and margin'' as used in § 226.24(f). Under the commentary, the time period during which an index and margin is considered reasonably current depends on the medium in which the advertisement was distributed. For direct mail advertisements, a reasonably current index and margin is one that was in effect within 60 days before mailing. For printed advertisements made available to the general public and for advertisements in electronic form, a reasonably current index and margin is one that was in effect within 30 days before printing, or 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.

Section 226.24(f)(4)—Envelope excluded. As 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.

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

The Board proposed 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. The final rule is modified from the proposal in that it allows alternative disclosures not only for information provided orally, but also for information provided in visual text in television advertisements. Some commenters noted a discrepancy between the Board's proposed § 226.24(g), which would not allow the alternative disclosures for visual text in television advertisements for closed-end credit, and proposed § 226.16(f), which would allow the alternative disclosures for visual text in television advertisements for open-end credit, and urged the Board to follow the approach found in § 226.16(f). The Board believes that the same reasoning that applies to allowing alternative disclosures in oral radio and television advertisements also applies to allowing alternative disclosures for visual text television advertisements and the final rule is revised accordingly. With one modification, § 226.24(g) follows the proposal for allowing alternative disclosures in radio and television advertisements. One option is to state clearly and conspicuously each of the disclosures required by § 226.24(d)(2) if a triggering term is stated in the advertisement. Another option is for the advertisement to state clearly and conspicuously the APR applicable to the loan, and the fact that the rate may be increased after consummation, if applicable. However, instead of 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, or a telephone number that allows a consumer to reverse the phone charges, that the consumer may call to receive more information. (The language from proposed comment 24(g)–1, which permitted the use of a telephone number that allows a consumer to reverse the phone charges, has been incorporated into the text of § 226.24(g), and proposed comment 24(g)–1 has been removed.) 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 is 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.

Section 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 proposed to add § 226.24(h) and comment 24(h)–1 to implement TILA Section 144(e). The Board's proposal applied the new requirements 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 sought comment on whether the new requirements should instead apply to only advertisements that state or imply that the creditor provides extensions of credit greater than the fair market value of the dwelling. Of the few commenters who addressed this issue, the majority were in favor of the alternative approach because many home-secured loans may, in some circumstances, allow for extensions of credit greater than the fair market value of the dwelling and advertisers would likely include the disclosure in nearly all advertisements.

The final rule differs from the proposed rule and requires that the additional tax implication disclosures be given only when an advertisement states that extensions of credit greater than the fair market value of the dwelling are available. The rule does not apply to advertisements that merely imply that extensions of credit greater than the fair market value of the dwelling may occur. By limiting the required disclosures to only those advertisements that state that extensions of credit greater than the fair market value of the dwelling are available, the Board believes the rule will provide the required disclosures to consumers when they are most likely to be receptive to the information while avoiding overloading consumers with information about the tax consequences of home-secured loans when it is less likely to be meaningful to them. Accordingly, proposed comment 24(h)–1 is removed as no longer necessary.

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

The Board proposed to add § 226.24(i) to prohibit the following seven acts or practices in connection with advertisements of closed-end mortgage loans: (1) The use of the term ''fixed'' to refer to rates or payments of closed-end home loans, unless certain conditions are satisfied; (2) comparison advertisements between actual and hypothetical rates and payments, unless certain conditions are satisfied; (3) falsely advertising a loan as government supported or endorsed; (4) displaying the name of the consumer's current lender without disclosing that the advertising mortgage lender is not affiliated with such current lender; (5) claiming debt elimination when one debt merely replaces another debt; (6) the use of the term ''counselor'' or ''financial advisor'' by for-profit brokers or lenders; and (7) foreign language advertisements that provide required disclosures only in English.

Pursuant to its authority under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), the Board is adopting § 226.24(i) substantially as proposed with modifications to § 226.24(i)(2) to clarify that the information required to be disclosed in comparison advertisements is the information required under § 226.24(f), to § 226.24(i)(6) to withdraw the prohibition on the use of the term ''financial advisor,'' and other modifications to clarify the scope and intent of the rule. The final rule applies only to closed-end mortgage loans. 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, 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.

The Board has sought to craft the rules carefully to make compliance with the requirements sufficiently clear and has provided additional examples in commentary to assist compliance with this rule. As discussed above, the Board is not extending the seven prohibitions on misleading advertisements to HELOCs because it has not been provided with, or found, sufficient evidence demonstrating that HELOC advertisements contain deceptive practices similar to those found in advertisements for closed-end mortgage loans. However, the Board may consider, as part of its larger review of HELOC rules, prohibiting certain misleading or deceptive practices if warranted. The Board notes that closed-end mortgage loan advertisements (as well as HELOCs) must continue to comply with all applicable state and federal laws, including Section 5 of the FTC Act.[121]

Public comment. The Board specifically sought comment on the appropriateness of the seven proposed prohibitions; whether the Board should prohibit any additional misleading or deceptive acts or practices; and whether the prohibitions should be extended to advertisements for open-end home equity lines of credit (HELOCs).

Consumer and community advocacy groups, associations of state regulators, federal agencies, and most industry commenters supported the Board's efforts to address misleading advertising acts and practices. Many creditors and their trade associations, however, urged the Board to use its authority under TILA Section 105(a), 15 U.S.C. 1604(a), rather than Section 129(l)(2), 15 U.S.C. 1639(l)(2), to prohibit certain advertising acts or practices for closed-end mortgage loans. These commenters expressed concern that promulgating the prohibitions under Section 129(l)(2) may expose creditors to extensive private legal action for inadvertent technical violations.

Commenters were divided on whether to extend the proposed prohibitions to HELOCs. Many community banks agreed with the Board that the misleading or deceptive acts often associated with mortgage and mortgage refinancing advertisements do not occur in HELOC advertisements. Some consumer groups and state regulators, however, urged the Board to extend all of the prohibitions to HELOCs. One large creditor offered specific suggestions on how to extend the prohibitions to HELOCs, while another sought extension of only the prohibition on the misleading use of the current lender's name. Few commenters suggested that the Board consider any additional prohibitions on misleading advertising either for closed-end mortgage loans or HELOCs. A more detailed discussion of the comments is provided below.

Section 226.24(i)(1)—Misleading advertising for ''fixed'' rates, payments or loans. Proposed § 226.24(i)(1) prohibited the use of the term ''fixed'' in advertisements for credit secured by a dwelling, unless certain conditions are satisfied, in three different scenarios: (i) Advertisements for variable-rate transactions; (ii) advertisements for non-variable-rate transactions in which the interest rate can increase; and (iii) advertisements that promote both variable-rate transactions and non-variable-rate transactions. The proposed rule prohibited 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.

The proposed rule also prohibited the use of the term ''fixed'' to refer to the payment in advertisements solely for non-variable-rate transactions where the payment will increase (for example, fixed-rate mortgage transactions with an initial lower payment that will increase), unless each use of the word ''fixed'' to refer to the 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 will increase after that period.

Finally, the proposed rule prohibited the use of the term ''fixed'' in advertisements that promote 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

[121] 15 U.S.C. 41 *et seq.*

fixed and, if used to refer to a payment, be 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 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.

Many creditors and their trade associations argued that the proposed prohibition contained many formatting and language requirements, and therefore could easily generate liability for technical, inadvertent errors. These commenters opposed the possible risk of civil liability for violations of this proposed rule and instead, urged the Board to use its authority under TILA Section 105(a), 15 U.S.C. 1604(a). One mortgage banking group suggested that if the Board promulgated the rule it should not prescribe detailed formatting rules but rather state that compliance with the rules governing trigger terms in § 226.24 satisfies compliance with this rule. Another bank commented that requiring disclosure after each use of the word ''fixed'' is excessive and suggested that the disclosure be required only once after the first use of the word.

In contrast, a number of consumer groups, as well as the FDIC and associations of state regulators, urged the Board to prohibit the use of the word ''fixed'' in advertisements for variable-rate mortgages, including ones that have a fixed-rate for a specified time period. They argued that the word ''fixed'' is confusing to consumers when used to reference any loan other than those that have rates (or payments) fixed for their entire term.

The Board is adopting the prohibition on the use of the term ''fixed'' to refer to rates or payments of closed-end home-secured loans as proposed with a modification to § 226.24(i)(1)(ii) to clarify application of the rule to non-variable-rate transactions. Based on its review of advertising copy, the Board finds that some 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 concludes that these types of advertisements are associated with abusive lending practices and also deceptive under the three-part test for deception set forth in Part V.A above.[122] The use of the word ''fixed'' in these advertisements is likely to 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. Consumers often shop for loans based on whether the term is fixed or not. Indeed, some credit counselors often encourage consumers to shop only for fixed-rate mortgages. Therefore, information about a mortgage loan's monthly payment or interest rate is important to consumers. As a result, the length of time for which the payment or interest rate will remain fixed is likely to affect a consumer's decision about whether to apply for a loan product.

The final rule does not, however, prohibit use of the word ''fixed'' in advertisements for home-secured loans where the use of the term is not misleading. Advertisements that refer to a rate or payment, or to the credit transaction, as ''fixed'' are 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. Use of the term ''fixed'' also is appropriate in an advertisement where the interest rate or payment may increase solely because the loan product features a preferred-rate or fixed-rate conversion provision (*see* comment 24(f)–1 for further guidance), or where the final scheduled payment in a fully amortizing loan is not greater than twice the amount of other regularly scheduled payments. The Board does not intend that this rule apply to the use of the word ''fixed'' in advertisements for home-secured loans that refers to fees or settlements costs.

The final rule does not ban the use of the term ''fixed'' in advertisements for variable rate products. The term ''fixed'' is used in connection with adjustable-rate mortgages, or with fixed-rate mortgages that include low initial payments that will increase. 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 time period. Such an advertisement demonstrates that there are legitimate and appropriate circumstances for using the term ''fixed'' in advertisements for variable-rate transactions.

Section 226.24(i)(2)—Misleading comparisons in advertisements. Proposed § 226.24(i)(2) prohibited any advertisement for credit secured by a dwelling from making any comparison between actual or hypothetical 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 clarified that a 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 did not propose to prohibit comparisons that take into account the consolidation of non-mortgage credit, such as auto loans, installment loans, or

[122] There must be a representation, omission or practice that is likely to mislead the consumer; the act or practice is examined from the perspective of a consumer acting reasonably in the circumstances; and 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.

revolving credit card debt, into a single, home-secured loan. However, the Board specifically sought 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.

Creditors and their trade groups, consumer and community advocacy groups, federal agencies, and associations of state regulators largely supported the proposed requirement that advertisements showing comparisons between actual or hypothetical rate or payments and the advertised rate or payment disclose information about the rates or payments that would apply for the term of the advertised loan and the period of time for which such rates or payments would be in effect. One mortgage banking trade group suggested that the proposed revisions to the trigger term requirements would sufficiently address issues with comparison advertisements and that a separate rule was unnecessary. Another commenter requested an exception for subordinate lien loans from the escrow disclosure component of the rule noting that the monthly payments of subordinate liens do not generally include escrows for taxes and insurance.

Commenters were divided on whether comparisons between non-mortgage debt and mortgage debt should be allowed. Industry commenters generally supported the Board's decision to allow debt consolidation advertisements that compare home-secured debt payments to other debt payments. They noted that debt consolidation offers consumers concrete benefits, such as increased cash flow or reduced interest rates, and that advertising communicated these choices to consumers. One bank commenter suggested that the Board require additional disclosures to alert consumers to the potential consequences of such debt consolidation, such as closing costs and loan duration. On the other hand, associations of state regulators urged the Board to ban debt consolidation comparison advertisements entirely. They argued that consumers could be misled about the risks and benefits of consolidating short-term unsecured debt into long-term secured debt.

One large bank, however, pointed out that the interest rates that could be disclosed for closed-end home-secured debt would be different than the rates for other kinds of secured debt in debt consolidation comparison advertisements. The commenter noted that under the proposed revisions to § 226.24(c), advertisements for home-secured loans would be allowed to use only the APR, which would include finance charges, while advertisements for other closed-end loans, such as auto loans, would be permitted to promote simple annual rates of interest along with APRs, and advertisements from open-end credit would be able to disclose APRs that did not have to include any finance charges.

The Board is adopting the prohibition proposed in § 226.24(i)(2) on the comparison of actual and hypothetical rates in advertisements unless certain conditions are satisfied. The final rule is modified to clarify that the information required to be disclosed in conjunction with the advertised rate or payment is the information required under §§ 226.24(f)(2) and (3). By referencing § 226.24(f), the final rule incorporates, without repeating, the requirements of that section. By referencing § 226.24(f)(3), the final rule exempts subordinate lien loans from the escrow disclosure component of the rule. In addition, the final rule maintains the proposed requirement that advertisements making comparisons to a variable-rate transaction, 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, must include 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.

Some advertisements for home-secured loans make comparisons between actual or hypothetical 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 these types of comparisons of rates and payments in advertisements to be deceptive under the three-part test for deception set forth in part V.A above. Making comparisons in advertisements can mislead a consumer 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. Information about the terms of the loan, such as rate and monthly payment, are material and likely to affect a consumer's decision about whether to apply for the advertised mortgage loan. Consumers may compare current obligations and the lower advertised rates or payments and conclude that the advertised loan product will offer them a better interest rate and/or monthly payment.

Some industry commenters requested that, consistent with § 226.24(f), the rule require information about amounts for taxes and insurance premiums only for advertisements for first-lien loans. By incorporating the requirements of § 226.24(f), the final rule excludes advertisements for subordinate lien loans from the requirement that the advertisement include a prominent statement in close proximity to the advertised payment that the payment does not include amounts for taxes and insurance premiums, if applicable. Monthly payments of subordinate lien loans do not generally require escrows for taxes and insurance and therefore are unable to include such amounts in any monthly payment calculation. Moreover, subordinate lien loans are generally advertised for the purpose of replacing or consolidating other subordinate lien loans or non-home secured obligations rather than home-secured first-lien loans.

The Board also is not banning debt consolidation advertisements or requiring additional disclosures about the cost or consequences of consolidating short term unsecured debt into longer term secured debt. The Board believes that 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. However, additional disclosures are unlikely to provide consumers with meaningful information at the advertising stage or be effective against aggressive push marketing tactics inherent in many advertisements.

Last, the Board emphasizes that under the final rule, the interest rate stated for a home-secured loan must be the APR.

The final rule permits, but does not require, an interest rate for any secured debt to be advertised also as a simple annual rate of interest. The Board notes that § 226.24(b) allows the simple annual interest rate that is applied to an unpaid balance to be stated so long as it is not advertised more conspicuously than the APR. Revisions to § 226.24(c) also allow the use of a simple annual rate of interest that is applied to an unpaid balance to be stated in an advertisement for a home-secured loan so long as it is not advertised more conspicuously than the APR. In addition, the Board's review of advertisements shows that many of the comparison advertisements compared monthly payments rather than interest rates, perhaps because comparison of monthly payments resonate more for consumers than comparison of interest rates.

Section 226.24(i)(3)—Misrepresentations about government endorsement. Proposed § 226.24(i)(3) prohibited statements about government endorsement 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 illustrated that a misrepresentation about government endorsement would include 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 because it conveys to the consumer a misleading impression that the advertised product is endorsed or sponsored by the federal government. No commenters objected to this prohibition.

The Board is adopting the rule as proposed. 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. Such advertisements can mislead consumers into believing that the government is guaranteeing, endorsing, or supporting the advertised loan product. Government-endorsed loans often offer certain benefits or features that may be attractive to many consumers and not otherwise available through private lenders. As a result, the fact that a loan product is associated with a government loan program can be a material factor in the consumer's decision to apply for that particular loan product. For these reasons, the Board finds these types of advertisements to be deceptive under the three-part test for deception set forth in part V.A above.

Section 226.24(i)(4)—Misleading use of the current mortgage lender's name. Proposed § 226.24(i)(4) prohibited 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.

Many creditors and their trade groups, state regulators, and other commenters offered strong support for the proposed prohibition on the misleading use of a consumer's current mortgage lender's name. State regulators noted that some states have similar requirements already in place and have a history of enforcement in this area. A credit union association suggested that the Board ban the use of a mortgage lender's name without that lender's permission outright, as is currently done in some states, rather than requiring a disclosure. A mortgage banking trade group and a large creditor suggested that the regulation clarify that the envelope or other mailing materials are part of any advertisement and that the required disclosure be closely proximate, as well as equally prominent, to the statement of the current lender's name.

The Board is adopting the rule as proposed. 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. For these reasons, the Board finds these types of advertisements to be deceptive under the three-part test for deception set forth in part V.A above.

Section 226.24(i)(5)—Misleading claims of debt elimination. Proposed § 226.24(i)(5) prohibited 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 provided 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 also clarified 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.

Most commenters supported the Board's proposal to prohibit misleading claims of debt elimination. A number of industry commenters also expressed support for the proposed commentary provision clarifying that advertisements could still claim to consolidate or reduce debt. However, one bank suggested that there were examples of non-misleading claims of debt elimination, such as ''eliminate high interest credit card debt.''

The Board is modifying the rule to clarify that only misleading claims of debt elimination are prohibited. Based on the advertising copy reviewed, 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. For these reasons, the Board finds these types of advertisements to be deceptive under the three-part test for deception set forth in part V.A above.

Section 226.24(i)(6)—Misleading use of the term ''counselor''. Proposed § 226.24(i)(6) prohibited advertisements for credit secured by a dwelling from using the terms ''counselor'' or ''financial advisor'' to refer to a for-profit mortgage broker or creditor, its employees, or persons working for the broker or creditor that are involved in offering, originating or selling mortgages. Nothing in the proposed rule prohibited 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. The final rule retains the prohibition on the use of the term ''counselor'' by for-profit brokers or creditors in advertisements for home-secured credit, but does not adopt the prohibition on the use of the term ''financial advisor'' for the reasons stated below.

A few creditors and financial services and securities industry associations argued that the proposed prohibition on the term ''financial advisor'' was too broad. These commenters noted that registered securities broker-dealers and other licensed financial professionals, who may also be licensed as mortgage brokers if required under applicable state law, may place advertisements for mortgage loans, often in conjunction with a range of other financial products. One large securities firm noted that its financial advisors routinely refer customers to its credit corporation subsidiary and that these financial advisors may place advertisements listing themselves as contact persons for a range of services and products, including residential mortgage loans. These commenters suggested that the Board provide a clear exception for registered securities broker-dealers and other investment advisors.

An association of certified mortgage planning specialists suggested a safe harbor for the use of the term ''financial advisor'' for those advertisers who have earned a title or designation that requires an examination or experience, adherence to a code of ethics, and continuing education. This commenter suggested that advertisers that did not have fiduciary relationships with consumers be required to include a disclaimer in their ads so stating.

The Board is not adopting the prohibition on the use of the term ''financial advisor'' as proposed in § 226.24(i)(6). The Board recognizes that financial advisors play a legitimate role in assisting consumers in selecting appropriate home-secured loans. The prohibition on the term ''financial advisor'' was intended to prevent creditors and brokers from falsely implying to residential mortgage consumers that they are acting in a fiduciary capacity when, in fact, they are not. However, the Board did not intend to prevent the legitimate business use of, or otherwise conflict or intervene with federal and state laws that contemplate the use of, the term ''financial advisor.'' [123]

For example, securities broker-dealers typically are registered by the U.S. Securities and Exchange Commission and/or licensed by a state regulatory agency to provide a range of financial advice and services on securities, insurance, retirement planning and other financial products, including residential mortgage loans. These registered securities broker-dealers currently use the term ''financial advisor'' in advertisements and solicitations. There are also other financial professionals who must meet certain federal or state professional standards, certifications or other requirements and use the term ''financial advisor'' because they are in the business of providing financial planning and advice. Examples include investment advisors, certified public accountants, and certified financial planners. Many of these professionals are obligated to act in the client's interest and disclose conflicts of interest (*i.e.*, owe a fiduciary obligation) and therefore, the use of the term ''financial advisor'' by such individuals is not misleading.[124] Because it is not practical to distinguish with sufficient clarity the legitimate uses of the term ''financial advisor'' in accordance with various federal or state laws, from improper use, the Board is withdrawing the prohibition on the term ''financial advisor.'' However, the Board notes that the use of the term ''financial advisor'' in mortgage advertisements must comply with all applicable state and federal laws, including the FTC Act.[125]

The Board is retaining the prohibition on the use of the term counselor. The Board believes that the exception to this prohibition for not-for-profit entities is sufficient to capture the legitimate use of this term. The use of the term counselor outside of this context is likely to mislead consumers into believing that the lender or broker has a fiduciary relationship with the consumer and is considering only the consumer's best interest. For these reasons, the Board finds these types of advertisements to be deceptive under the three-part test for deception set forth in part V.A above.

Section 226.24(i)(7)—Misleading foreign-language advertisements. Proposed § 226.24(i)(7) prohibited 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 provide disclosures entirely in English or entirely in a foreign language would not be affected by this prohibition.

Most commenters expressed support for the prohibition on advertising triggering information in a foreign language and then providing information about other trigger terms or required disclosures in English.

The Board is adopting the rule as proposed. 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. Some of these advertisements, however, provide information about some trigger terms or required disclosures, such as a low introductory ''teaser'' rate or payment, in a foreign language, but provide information about other trigger terms or required disclosures, such as the fully-indexed rate or fully amortizing payment, 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. For these reasons, the Board finds these types of advertisements to be deceptive under the three-part test for deception set forth in part V.A above.

XII. Mortgage Loan Disclosures

A. Early Mortgage Loan Disclosures—§ 226.19

Pursuant to its authority under TILA Section 105(a), 15 U.S.C. 1604(a), the Board proposed to require creditors to give consumers transaction-specific, early mortgage loan disclosures for closed-end loans secured by a consumer's principal dwelling, including refinancings, home equity loans (other than HELOCs) and reverse mortgages. The proposed rule would require that creditors deliver this disclosure not later than three business days after application and before a consumer pays a fee to any person, other than a fee for obtaining the consumer's credit history. The Board also proposed corresponding changes to the staff commentary and certain other conforming amendments to Regulation Z. Providing the mortgage loan disclosure early for all mortgage transactions, and before consumers have paid significant fees, would help consumers make informed use of credit and better enable them to shop among available credit alternatives.

The Board is adopting § 226.19(a)(1) as proposed, with new commentary to

[123] *See, e.g.*, Investment Advisors Act of 1940, 14 U.S.C. 80b–1 *et seq.*; Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*

[124] 14 U.S.C. 80b–1 *et seq.*

[125] 15 U.S.C. 41 *et seq.*

address concerns about application of the fee restriction to third parties, such as mortgage brokers. The early mortgage loan disclosure rule is effective for loans for which a creditor has received an application on or after October 1, 2009.

Public Comment

The Board sought comment on whether the benefits of requiring the early mortgage loan disclosure would outweigh operational or other costs, and whether further guidance was necessary to clarify what fees would be deemed in connection with an application.

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

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

Discussion

TILA Section 128(b)(1), 15 U.S.C. 1638(b)(1), provides that the closed-end credit disclosure (mortgage loan disclosure), which includes the APR and other material disclosures, must be delivered ''before the credit is extended.'' Regulation Z currently implements this statutory provision by allowing creditors to provide the disclosures at any time before consummation. TILA Section 128(b)(2) and § 226.19 of Regulation Z apply to ''residential mortgage transactions'' subject to RESPA and require that ''good faith estimates'' of the mortgage loan disclosure be made before the credit is extended, or delivered 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). A residential mortgage transaction includes loans to finance the acquisition or initial construction of a consumer's dwelling but does not include refinance or home-equity loans. The Board proposed to amend Regulation Z to implement TILA Section 128(b)(1) in a manner that would require the disclosures earlier in the mortgage transaction, rather than at any time before consummation, which would result in a requirement similar to TILA Section 128(b)(2).

The final rule is issued pursuant to TILA Section 105(a), which mandates that the Board prescribe regulations to carry out TILA's purposes. 15 U.S.C. 1604(a). TILA Section 102(a) provides, in pertinent part, that TILA's purposes are to assure a meaningful disclosure of credit terms so that the consumer is better able to compare various credit terms available and avoid the uninformed use of credit. 15 U.S.C. 1601(a). The final rule is intended to help consumers make informed use of credit and shop among available credit alternatives.

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

The early mortgage loan disclosure required by the final rule will provide information to consumers about the terms of the loan, such as the payment schedule, earlier in the shopping process. For example, ARMs may have a low, initial fixed rate period followed by a higher variable rate based on an index plus margin. Some fixed rate loans also may have a temporary initial rate that is discounted. These loans may be marketed to consumers on the basis of the low initial payment or the low initial interest rate. The payment schedule will show the increases in monthly payments when the rate increases. It will also show an APR for the full loan term based on the fully indexed rate instead of the initial rate. Providing this information not later than three business days after application, and before the consumer has paid a substantial fee, will help ensure that consumers have a genuine opportunity to review the credit terms offered; that the terms are consistent with their understanding of the transaction; and that the credit terms meet their needs and are affordable. This information will further enable the consumer to decide whether to move forward with the transaction or continue to shop among alternative loan products and sources of credit.

The Board recognizes that the early mortgage loan disclosure rule will impose additional costs on creditors, some of which may be passed on in part to consumers. Because early disclosures currently are required for home purchase loans, some creditors already deliver early mortgage loan disclosures on non-purchase mortgages. Not all creditors, however, follow this practice, and they will also incur one-time implementation costs to modify their systems in addition to ongoing costs to originate loans. The Board believes, however, that the benefits to consumers of receiving early estimates of loan terms, such as enhanced shopping and competition, offset any additional costs.

The Final Rule

For the reasons discussed below, the Board is adopting the rule as proposed with new staff commentary to address, through examples, the application of the fee restriction to third parties, such as mortgage brokers. The final rule applies to all closed-end loans secured by a consumer's principal dwelling (other than HELOCs) and requires creditors to deliver the early mortgage loan disclosure to consumers no later than three business days after application and before any fee is paid, other than a fee for obtaining the consumer's credit history, such as a credit report.

Third party originators. The Board proposed § 226.19(a)(1)(ii) to prohibit a creditor or any other person from collecting a fee, other than a fee for obtaining the consumer's credit history, until the early mortgage loan disclosure is received by the consumer.

Many creditors and their trade associations argued that the fee restriction would be difficult or impossible to apply and monitor in the wholesale channel, especially with respect to appraisal fees. These commenters noted that third parties, such as mortgage brokers, submit consumer applications to multiple creditors; they expressed concern that under the proposal lenders might have to refuse to accept a new application where the consumer has already paid a fee to a prior creditor but then withdrew the first application or had it denied.

Most creditors also expressed concern that the phrase ''any other person'' would require them to monitor the timing of fees paid to brokers, and stated that they could not track such information accurately. Many creditors requested that the Board clarify whether creditors would have to refuse applications submitted by a broker that already had obtained a fee from the consumer (other than a fee for obtaining the consumer's credit history) because it would be too late for creditors to comply with the timing requirement of the early mortgage loan disclosure. A few commenters urged the Board to limit the fee restriction to fees collected only by creditors.

The Board is adopting the proposed rule without modification but is adding comment 19(a)(1)(ii)–3 to clarify the rule's treatment of applications submitted by third parties, such as mortgage brokers, and to provide examples of compliance with the rule. A broker's submission of a consumer's information (registration) to more than one creditor, and the layered underwriting and approval process that occurs in the wholesale channel, may complicate implementation of the fee restriction. Generally a broker submits a consumer's written application (the trigger for early TILA disclosures under § 226.19(a)(1)(i)) to only one creditor based on product offerings, the consumer's choice, and other factors. Under the final rule, once the creditor receives the consumer's written application, the creditor must provide the early mortgage loan disclosure after which the creditor and/or the broker may collect fees (other than a fee for obtaining the consumer's credit history) from the consumer. However, after the collection of fees, the creditor may engage in further underwriting that could result in a denial of the consumer's application. The broker may then submit the application to a different creditor who must also comply with the final rule.

The Board proposed to regulate the collection of fees by ''any other person'' in § 226.19(a)(1)(ii) to avoid circumvention of the fee restriction. However, in some circumstances it may not be reasonable to expect creditors to know whether the consumer paid a fee to a broker before receiving the early mortgage loan disclosure. Therefore, the Board is adding new comment 19(a)(1)(ii)–3 to illustrate through examples when creditors are in compliance with § 226.19(a)(1)(ii). The new commentary addresses the situation where a mortgage broker submits a consumer's written application to a new creditor because a prior creditor denied the consumer's mortgage application, or the consumer withdrew the application, but the consumer already paid a fee to the prior creditor (aside from a fee for obtaining the consumer's credit history). The comment clarifies that in this situation, the new creditor or third party complies with § 226.19(a)(1)(ii) if it does not collect or impose any additional fee until after the consumer receives an early mortgage loan disclosure from the new creditor.

Many creditors also stated that the rule would inappropriately require them to monitor the actions of third parties. Although the rule does not require creditors to take specific action with respect to monitoring third parties, creditors must comply with this rule whether they deal with consumers directly or indirectly through third parties. Creditors that receive applications through a third party may choose to require through contractual arrangement that the third party include with a consumer's written application a certification, for example, that no fee has been collected in violation of § 226.19(a)(1). The Board also notes that the federal banking agencies have issued guidance that addresses, among other things, systems and controls that should be in place for establishing and maintaining relationship with third parties.[126]

The Board recognizes that unscrupulous third parties may not comply with the fee restriction, regardless of contractual obligations. The Board may consider, as part of its overall review of closed-end disclosures, whether it should propose rules that would directly prohibit third parties from collecting a fee before the consumer receives the early mortgage loan disclosure, other than a fee for obtaining the consumer's credit history.

Scope of the fee restriction. Regulation Z currently does not prohibit creditors from collecting any fee before giving consumers the closed-end credit disclosures required by § 226.19(a)(1). The Board proposed in § 226.19(a)(1)(ii) to prohibit the collection of any fee, other than a fee for obtaining the consumer's credit history, until after the consumer receives the early mortgage loan disclosure. Most industry commenters urged the Board to broaden the fee exception to include, for example, rate lock, appraisal and flood certification fees. They argued that prohibiting these fees could harm consumers in a rising interest rate environment, delay consumers' access to credit (for example, delay conditional approvals, application processing, closing and funding of loans), and reverse the benefits of automated and streamlined mortgage loan processing. Some commenters urged alternatively that the Board restrict only the imposition of nonrefundable fees. In contrast, state regulators urged the Board to tighten the fee restriction, noting that allowing the collection of credit report fees will conflict with many state laws.

The Board is adopting the rule regarding the fee restriction as proposed. Consumers typically pay fees to apply for a mortgage loan, such as fees for a credit report, a property appraisal, or an interest rate lock, as well as general ''application'' fees to process the loan. If the fees are significant, as they often are for appraisals and for extended rate locks, consumers may feel constrained from shopping for alternative loans because they feel financially committed to the transaction. 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 shopping for mortgage loans, as discussed in more detail in part II. The risk also applies to the prime market, where many consumers would find a fee of several hundred dollars, such as the fee often imposed for an appraisal and other services, to be costly enough to deter them from shopping further among alternative loans and sources. Limiting the fee restriction to nonrefundable fees also would likely undermine the intent of the rule. Consumers, especially those in the subprime market, may not have sufficient cash to pay ''refundable fees'' to multiple creditors, and therefore would be discouraged from shopping or otherwise unable to obtain multiple early mortgage loan disclosures to compare credit terms.

In addition, the definition of ''business day'' under § 226.2(a)(6) is being revised for purposes of the consumer's receipt of early mortgage loan disclosures under § 226.19(a)(1)(ii). Existing § 226.2(a)(6) contains two definitions of ''business day.'' Under the standard definition, a business day means a day on which the creditor's offices are open to the public for carrying on substantially all of its business functions. However, for purposes of rescission under §§ 226.15 and 226.23, and for purposes of

[126] *See, e.g., Nontraditional Mortgage Guidance.*

§ 226.31, a ''business day'' means all calendar days except Sundays and specified legal public holidays. The definition of ''business day'' is being revised to apply the second definition of business day to the consumer's receipt of early mortgage loan disclosures under § 226.19(a)(1)(ii). The Board believes that the definition of business day that excludes Sundays and legal public holidays is more appropriate because consumers should not be presumed to have received disclosures in the mail on a day on which there is no mail delivery.

Under the final rule, creditors may presume that the consumer receives the early mortgage loan disclosure three business days after mailing. For example, a creditor that puts the early mortgage loan disclosure in the mail on a Friday can presume that the consumer receives such disclosure the following Tuesday, and impose appraisal, rate-lock and other application fees after midnight on Tuesday (assuming there are no intervening legal public holidays). The Board does not believe that the rule delaying the collection of fees will have a significant negative impact on the mortgage loan application and approval process. Three business days sets an appropriate timeframe for the consumer to receive and review the early mortgage loan disclosure. It is not always practical for a creditor to know when a consumer will actually receive the early mortgage loan disclosure. Creditors can choose among many different methods to deliver the disclosures to consumers, such as by overnight delivery service, e-mail or regular postal mail. In most instances consumers will receive the early mortgage loan disclosure within three business days, and the Board notes that it is common industry practice to deliver mortgage disclosures by overnight courier.

The Board contemplated providing a longer timeframe for the presumption of receipt of the early mortgage loan disclosure. Some originators could delay hiring an appraiser until after the consumer pays an appraisal fee, which would delay the appraisal report and the processing time for the application. Some creditors may refuse to lock-in the interest rate until after the consumer pays a rate lock fee, or alternatively lock-in the interest rate and bear some market risk or cost until it can impose a rate lock fee on the consumer. The Board believes the three business day time frame for the fee restriction strikes a proper balance between enabling consumers to review their credit terms before making a financial commitment and maintaining the efficiency of automated and streamlined loan processing.

Presumption of receipt. Proposed § 226.19(a)(1)(ii) provided that a fee may not be imposed until after a consumer has received the early mortgage loan disclosure and that the consumer is presumed to receive the disclosure three business days after it is mailed. Proposed comment 19(a)(1)(ii)–1 clarified further that creditors may charge a consumer a fee, in all cases, after midnight of the third business day following mailing the disclosure, and for disclosures delivered in person, fees may be charged anytime after delivery.

One commenter addressed the receipt of disclosures sent by mail and suggested that the Board consider: (1) A presumption that disclosures sent by overnight courier are received by the consumer the next day; and (2) a presumption that disclosures delivered by electronic communication in compliance with applicable requirements under the Electronic Signatures in Global and National Commerce Act (''E–Sign Act''), 15 U.S.C. 7001 *et seq.,* are received by the consumer immediately.

The Board considered but is not adopting rules for overnight courier and other delivery methods. For example, overnight courier companies do not appear to adhere to one generally accepted definition for ''overnight delivery''; it may mean next business day or next calendar day. Recognized holidays and business hours also affect what is considered overnight delivery. In light of these variations the Board believes it is not feasible to define with sufficient clarity what may be considered acceptable ''overnight delivery'' or to delineate a presumption of receipt for all available methods of delivery.

In addition, although the final rule provides a presumption of receipt if the early mortgage loan disclosure is delivered by mail, it does not prevent creditors from choosing any permissible method available to deliver the early mortgage loan disclosure, such as overnight courier or e-mail if in compliance with the E–Sign Act. Creditors may impose such fees any time after the consumer actually receives the early mortgage loan disclosure. Evidence of receipt by the consumer, such as documentation that the mortgage loan disclosure was delivered by certified mail, overnight delivery, or e-mail (if similar documentation is available), is sufficient to establish compliance with § 226.19(a)(1)(ii).

Exception to fee restriction. Proposed § 226.19(a)(1)(iii) provided that a fee for obtaining the consumer's credit history may be charged before the consumer receives the early mortgage loan disclosure, provided the fee is ''*bona fide* and reasonable in amount.'' Many creditors and their trade associations noted that different pricing schedules make it difficult to ascertain the exact cost of a credit report and urged the Board to allow creditors to charge a flat or nominal fee for the credit report.

The Board is adopting § 226.19(a)(1)(iii) as proposed. The final rule recognizes that creditors generally cannot provide accurate transaction-specific cost estimates without having considered the consumer's credit history. Requiring creditors to bear the cost of reviewing credit history with little assurance the consumer will apply for a loan would be unduly burdensome. Some creditors might forego obtaining the consumer's credit history; disclosures made without any credit risk assessment of the consumer are likely to be of little value to the consumer.

The language ''*bona fide* and reasonable in amount,'' in § 226.19(a)(1)(iii) does not require the creditor to charge the consumer the actual cost incurred by the creditor for that particular credit report, but rather contemplates a reasonable and justifiable fee. Many creditors enter into arrangements where pricing varies based on volume of business or other legitimate business factors, which makes the exact charge imposed on a particular consumer difficult to determine. The Board believes that a fee that bears a reasonable relationship to the actual charge incurred by the creditor is ''*bona fide* and reasonable in amount.''

Enhanced civil remedies and redisclosure. The Board proposed the early mortgage loan disclosure pursuant to its authority under TILA Section 105(a), 15 U.S.C. 1604(a). Consumer advocacy groups generally support the early mortgage loan disclosure, but urged the Board to allow for civil enforcement to ensure compliance. They argued that without enhanced remedies, the disclosures could become instruments for ''bait and switch'' schemes. Specifically, consumer groups urged the Board to use its authority under TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), in addition to Section 105(a), and declare that failure to deliver timely and accurate early disclosures is an unfair and deceptive practice subject to enhanced damages under Section 129(l)(2). Consumer groups also argued that the early mortgage loan disclosure should be considered a material disclosure subject to remedies available under TILA Section 130(a)(4), 15 U.S.C. 1640(a)(4) and extended rescission rights.

The Board is adopting the final rule as proposed, pursuant to its authority under TILA Section 105(a), 15 U.S.C. 1604(a). The early mortgage loan disclosure is an early good faith estimate of transaction-specific terms, such as the APR and payment schedule. Although the Board shares commenters' concerns about bait and switch tactics, responsible creditors may not know the precise credit terms to disclose, and therefore must provide estimates, because the disclosure must be provided before the underwriting process is complete. However, through its review of closed-end mortgage disclosures, the Board may determine that some requirement for accuracy of the early disclosures is feasible.

Consumer groups and others also suggested that the Board require redisclosure of the early mortgage loan disclosure some time period (*e.g.,* at least seven days) before consummation if there have been material changes. They asserted that an inaccurate or misleading early disclosure could cause consumers to stop shopping based on erroneous credit terms. Under current § 226.19(a)(2), redisclosure already is required no later than consummation and industry practice is to give the consumer a final TILA at closing, which does not facilitate shopping. The final rule does not revise the requirements for redisclosure prior to consummation. The Board may consider the need for additional rules as part of its overall review of closed-end mortgage disclosures.

B. Plans To Improve Disclosure

Most creditors and their trade associations, citing the HUD's current RESPA proposal and the 1998 Federal Reserve Board and HUD Joint Report to the Congress Concerning Reform to TILA and RESPA, urged the Board to delay the proposed early mortgage loan disclosure rule and make it part of broader disclosure reform, or at least part of the comprehensive review of Regulation Z's closed-end rules that the Board is conducting currently.

The Board believes that better information in the mortgage market can improve competition and help consumers make better decisions. The final rule is designed, in part, to prevent incomplete or misleading mortgage loan advertisements and solicitations, and to require creditors to provide mortgage disclosures earlier so that consumers can get the information they need when it is most useful to them. The Board recognizes that the content and format of these required early mortgage loan disclosures may need to be updated to reflect the increased complexity of mortgage products. The Board is reviewing current TILA mortgage disclosures and potential revisions to these disclosures through consumer testing. The Board expects that this testing will identify potential improvements for the Board to propose for public comment in a separate rulemaking. In addition, the Board will continue to have discussions with HUD to improve mortgage disclosures.

XIII. Mandatory Compliance Dates

Under TILA Section 105(d), certain of 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. 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 finds that such action is necessary to prevent unfair or deceptive disclosure practices. No similar effective date requirement exists for non-disclosure regulations.

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

Early TILA Disclosures

Pursuant to Section 105(d), the requirement to provide consumers with transaction-specific mortgage loan disclosures under § 226.19 applies to all applications received on or after October 1, 2009. Although state regulators noted that some creditors already have systems in place to provide early mortgage loan disclosures to comply with state law requirements, creditors and their trade groups generally urged the Board to allow more lead time than six months to comply to provide sufficient time for system re-programming, testing, procedural changes, and staff training.

The early mortgage disclosure rule is triggered by the date of receipt of a consumer's written application, and therefore all written applications received by creditors on or after October 1, 2009 must comply with § 226.19. Existing comment 19(a)(1)–3 (redesignated as comment 19(a)(1)(i)–3) states that a written application is deemed received when it reaches the creditor in any of the ways applications are normally transmitted, such as mail, hand delivery or through a broker.

For example, a creditor that receives a consumer's written application for a mortgage refinancing on September 30, 2009, and which is consummated on October 29, 2009, does not need to deliver an early mortgage loan disclosure to the consumer and otherwise comply with the fee restriction requirements of this rule. A creditor that receives a consumer's written application on October 1, 2009 must deliver to the consumer an early mortgage loan disclosure within three business days and before the consumer pays a fee to any person, other than a fee for obtaining the consumer's credit history. The creditor may impose a fee on the consumer, such as for an appraisal or underwriting, after the consumer receives the disclosure. Under § 226.19(a)(1)(ii) the consumer is presumed to have received the early mortgage loan disclosure three business days after it is mailed, and therefore, the creditor may impose a fee after midnight on the third business day following mailing.

Escrow Rules

As described in part IX.D, although many creditors currently provide for escrows, large creditor commenters and their trade associations requested that this provision be delayed by 12 to 24 months to allow creditors that currently have no escrowing capacity or infrastructure to implement the necessary systems and processes.

Manufactured housing industry commenters were particularly concerned because, as described in Part IX.D, currently a limited infrastructure is in place for escrowing on manufactured housing loans. Accordingly, the requirement to establish an escrow account for taxes and insurance (§ 226.35(b)(3)) for higher-priced mortgage loans is effective for such loans for which creditors receive applications on or after April 1, 2010. For higher-priced mortgage loans secured by manufactured housing, however, compliance is mandatory for such loans for which creditors receive applications on or after October 1, 2010.

Advertising Rules and Other Rules Adopted Under TILA Section 129(l)(2)

The final advertising rules are effective for advertisements occurring on or after October 1, 2009. For example, the advertising rules would be applicable to radio advertisements broadcast on or after October 1, 2009, or for solicitations mailed on or after October 1, 2009. The servicing rules are effective for any loans serviced on or after October 1, 2009, whether the servicer obtained servicing rights on the loan before or after that date. The remaining rules are effective for loans for which a creditor receives an application on or after October 1, 2009.

Application of Mandatory Compliance Dates; Pre-Existing Obligations

As described above, the final rule is prospective in application. Sometimes a change in the terms of an existing obligation constitutes a refinancing, which is a new transaction requiring new disclosures. An assumption, where the creditor agrees in writing to accept a subsequent consumer as a primary obligor, is also treated as a new transaction. *See* 12 CFR 226.20(a) and (b). A refinancing or assumption is covered by a provision of the final rule if the transaction occurs on or after that provision's effective date. For example, if a creditor receives an application for a refinancing on or after October 1, 2009, and the refinancing is consummated on October 15, 2009, the provision restricting prepayment penalties in § 226.35(b)(2) applies, but the escrow requirement in § 226.35(b)(3) would not apply because the escrow provision is only effective for new transactions where the application is received on or after April 1, 2010 (or October 1, 2010 for manufactured housing-secured loans). However, if a modification of an existing obligation's terms that does not constitute a refinancing under § 226.20(a) occurs on October 15, 2009, the restriction on prepayment penalties would not apply. Nevertheless, the loan servicing rules in § 226.36(c) will apply to loan servicers as of October 1, 2009, regardless of when the creditor received the application or consummated the transaction.

XIV. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3506; 5 CFR part 1320 app. A.1), the Board reviewed the final 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 final rulemaking is found in 12 CFR part 226. The Board 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. Since the Board does not collect any information, no issue of confidentiality normally arises. However, in the event the Board were to retain records during the course of an examination, the information may be protected from disclosure under the exemptions (b)(4), (6), and (8) of the Freedom of Information Act (5 U.S.C. 522(b)).

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 24 months, 12 CFR 226.25, but Regulation Z does not specify the types of records that must be retained.

Under the PRA, the Board accounts for the paperwork burden associated with Regulation Z for the state member banks and other creditors supervised by the Board 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. To ease the burden and cost of complying with Regulation Z (particularly for small entities), the Board provides model forms, which are appended to the regulation.

As mentioned in the Preamble, on January 9, 2008, a notice of proposed rulemaking (NPR) was published in the **Federal Register** (73 FR 1672). The comment period for this notice expired on April 8, 2008. No comments specifically addressing the burden estimate were received; therefore, the burden estimates will remain unchanged as published in the NPR. The final rule will impose a one-time increase in the total annual burden under Regulation Z by 46,880 hours from 552,398 to 599,278 hours. This burden increase will be imposed on all Federal Reserve-regulated institutions that are deemed to be respondents for the purposes of the PRA. Note that these burden estimates do 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 Board has a continuing interest in the public's opinions of our collections of information. At any time, comments regarding the burden estimate, or any other aspect of this collection of information, including suggestions for reducing the burden, may be sent to: Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100–0199), Washington, DC 20503.

XV. Regulatory Flexibility Analysis

In accordance with section 4 of the Regulatory Flexibility Act (RFA), 5 U.S.C. 601–612, the Board is publishing a final regulatory flexibility analysis for the proposed amendments to Regulation Z. The RFA requires an agency either to provide a final regulatory flexibility analysis with a final rule or certify that the final 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.[127]

The Board received a large number of comments contending that the proposed rule would have a significant impact on various businesses. In addition, the Board received one comment on its initial regulatory flexibility analysis. Based on public comment, the Board's own analysis, and for the reasons stated below, the Board believes that this final rule will have a significant economic impact on a substantial number of small entities.

1. Statement of the Need for, and Objectives of, the Final Rule

The Board is publishing final rules to establish new regulatory protections for consumers in the residential mortgage market through amendments to Regulation Z, which implements TILA and HOEPA. As stated more fully above, the amendments are intended to protect consumers in the mortgage market from unfair, abusive, or deceptive lending and servicing acts or practices while preserving responsible lending and sustainable homeownership. Some of the restrictions apply to only higher-priced mortgage loans, while others apply to all mortgage loans secured by a consumer's principal dwelling. For example, for higher-priced mortgage loans, the amendments prohibit lending based on the collateral without regard to consumers' ability to repay their obligations from income, or from other sources besides the collateral. In addition, the amendments' goals are to ensure that advertisements for mortgage credit provide accurate and balanced information and do not contain misleading or deceptive representations; and to provide consumers transaction-specific disclosures early enough to use while shopping for a mortgage.

2. Summary of Issues Raised by Comments in Response to the Initial Regulatory Flexibility Analysis

In accordance with section 3(a) of the RFA, 5 U.S.C 603(a), the Board prepared an initial regulatory flexibility analysis (IRFA) in connection with the proposed rule, and acknowledged that the projected reporting, recordkeeping, and other compliance requirements of the proposed rule would have a significant economic impact on a substantial number of small entities. In addition, the Board recognized that the precise compliance costs would be difficult to ascertain because they would depend on a number of unknown factors, including, among other things, the specifications of the current systems used by small 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. The Board sought information and comment on any costs, compliance requirements, or changes in operating procedures arising from the application of the proposed rule to small entities. The Board recognizes that businesses often pass compliance costs on to consumers and that a less costly rule could benefit both small business and consumers.

The Board reviewed comments submitted by various entities in order to ascertain the economic impact of the proposed rule on small entities. A number of financial institutions and mortgage brokers expressed concern that the Board had underestimated the costs of compliance. In addition, the Office of Advocacy of the U.S. Small Business Administration (Advocacy) submitted a comment on the Board's IRFA. Executive Order 13272 directs Federal agencies to respond in a final rule to written comments submitted by Advocacy on a proposed rule, unless the agency certifies that the public interest is not served by doing so. The Board's response to Advocacy's comment letter is below.

Response to U.S. Small Business Administration comment. Advocacy supported the consumer protection goals in the proposed rule, but expressed concern that the Board's IRFA did not adequately assess the impact of the proposed rule on small entities as required by the RFA. Advocacy urged the Board to issue a new proposal containing a revised IRFA. For the reasons stated below, the Board believes that its IRFA complied with the requirements of the RFA and the Board is proceeding with a final rule.

Advocacy suggested that the Board failed to provide sufficient information about the economic impact of the proposed rule and that the Board's request for public comment on the costs to small entities of the proposed rule was not appropriate. Section 3(a) of the RFA requires agencies to publish for comment an IRFA which shall describe the impact of the proposed rule on small entities. 5 U.S.C 603(a). In addition, section 3(b) requires the IRFA to contain certain information including a description of the projected reporting, recordkeeping and other compliance requirements of the proposed rule, including an estimate of the classes of small entities which will be subject to the requirement and the type of professional skills necessary for preparation of the report or record. 5 U.S.C. 603(b).

The Board's IRFA complied with the requirements of the RFA. First, the Board described the impact of the proposed rule on small entities by describing the rule's proposed requirements in detail throughout the supplementary information for the proposed rule. Second, the Board described the projected compliance requirements of the rule in its IRFA, noting the need for small entities to update systems, disclosures and underwriting practices.[128] The RFA does not require the Board to undertake an exhaustive economic analysis of the proposal's impact on small entities in the IRFA. Instead, the IRFA procedure is intended to evoke commentary from small businesses about the effect of the rule on their activities, and to require agencies to consider the effect of a regulation on those entities. *Cement Kiln Recycling Coalition* v. *EPA*, 255 F.3d 855, 868 (D.C. Cir. 2001). The Board described the projected impact of the proposed rule and sought comments from small entities themselves on the effect the proposed rule would have on their activities. The Board also notes that the final rule does not adopt the proposed rule on creditor payments to mortgage brokers, reducing the final rule's impact on small mortgage broker entities.

Advocacy also commented that the Board failed to provide sufficient information about the number of small mortgage brokers that may be impacted by the rule. Section 3(b)(3) of the RFA requires the IRFA to contain a description of and, where feasible, an estimate of the number of small entities to which the proposed rule will apply. 5 U.S.C. 603(b)(3) (emphasis added). The Board provided a description of the

[127] 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.*

[128] 73 FR 1672, 1720 (Jan. 9, 2008).

small entities to which the proposed rule would apply and provided an estimate of the number of small depository institutions to which the proposed rule would apply.[129] The Board also provided an estimate of the total number of mortgage broker entities and estimated that most of these were small entities.[130] The Board stated that it was not aware of a reliable source for the total number of small entities likely to be affected by the proposal.[131] Thus, the Board did not find it feasible to estimate their number.

Advocacy also suggested that the Board's IRFA did not sufficiently address alternatives to the proposed rule. Section 3(c) of the RFA requires that an IRFA contain a description of any significant alternatives to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the proposed rule on small entities. 5 U.S.C. 603(c). The Board's IRFA discusses the alternative of improved disclosures and requests comment on other alternatives. Advocacy commented that the Board's IRFA does not discuss the economic impact that the disclosure alternative would have on small entities. Yet the Board's IRFA discussion of the disclosure alternative indicates that the Board does not believe that the disclosure alternative would accomplish the stated objectives of applicable statutes.[132] Advocacy also suggested that the Board did not discuss other alternatives such as a later implementation date. However, the Board specifically discussed and requested comment on the effective date in another section of the supplementary information to the proposed rule.[133] Section 5(a) of the RFA permits an agency to perform the IRFA analysis (among others) in conjunction with or as part of any other analysis required by any other law if such other analysis satisfies the provisions of the RFA. 5 U.S.C. 605(a). Other alternatives were discussed throughout the supplementary information to the Board's proposal.

Other comments. In addition to Advocacy's comment letter, a number of industry commenters expressed concerns that the rule, as proposed, would be costly to implement, would not provide enough flexibility, and would not adequately respond to the needs or nature of their business. Many commenters argued that 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. As discussed in part XII, while the Board anticipates proposing improvements to mortgage loan disclosures, the Board believes that better disclosures alone would not adequately address unfair, abusive or deceptive practices in the mortgage market, including the subprime market. Since improved disclosures alone would fail to accomplish the stated objectives of TILA Section 129(l)(2), which authorizes the Board to prohibit unfair or deceptive practices in connection with mortgage loans, the Board concluded that improved disclosures alone do not represent a significant alternative to the proposed rule, as a result of which the IRFA did not discuss the economic impact of improved disclosures.

Many of the issues raised by commenters do not apply uniquely to small entities and are addressed above in other parts of the **SUPPLEMENTARY INFORMATION**. The comments that expressed specific concerns about the effect of the proposed rule on small entities are discussed below.

Defining loans as higher-priced. The proposed rule defined higher-priced mortgage loans as loans with an 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. Some small banks, community banks and manufactured housing representatives expressed concerns that, based on the proposed definition of higher-priced mortgage loans, some prime loans may be classified as higher-priced, which could have negative impact on their business. Many of these commenters proposed changing the definition of higher-priced mortgage loans, and manufactured housing industry representatives proposed a separate standard for personal property loans on manufactured homes.

As discussed above, the Board is adopting a definition of ''higher-priced mortgage loan'' that is similar in concept to the definition proposed, but different in the particulars. The final definition, like the proposed definition, sets a threshold above a market rate to distinguish higher-priced mortgage loans from the rest of the mortgage market. Instead of yields on Treasury securities, the definition in the final rule uses a survey-based estimate of market rates for the lowest-risk prime mortgages, referred to as the average prime offer rate. The Board believes that the final rule will more effectively meet both goals of covering prime loans and excluding prime, though it will cover some prime loans under certain market conditions.

Escrows. The proposed rule would require creditors to establish escrow accounts for taxes and insurance and permitted them to allow borrowers to opt out of escrows 12 months after loan consummation. Several industry commenters noted that the compliance with the escrow proposal would be costly and many small banks and community banks commented that they do not currently require escrows because of this cost. A few small lenders commented that the costs of setting up escrow accounts are prohibitively expensive but did not disclose what such costs are. Manufactured housing industry commenters were especially concerned about the cost of requiring escrows for manufactured homes that are taxed as personal property because there is no unified, systematic process for the collection of personal property taxes among various government entities.

The final rule is adopted substantially as proposed. As discussed above, the Board does not believe that alternatives to the final rule would achieve HOEPA's objectives. The Board has, however, chosen effective dates for the final rule that give creditors a longer implementation period for establishing escrow accounts. Comments on the effective dates of the final rule are discussed below.

Broker disclosures. The Board proposed to prohibit creditors from paying a mortgage broker more than the consumer had agreed in advance that the broker would receive. A large number of mortgage brokers commented that the proposal could lead to brokers being less competitive in the marketplace and may result in some small brokers exiting the marketplace.

The Board tested the proposal in several dozen one-on-one interviews with a diverse group of consumers. On the basis of this testing and other information, the Board is withdrawing its proposal to prohibit creditors from paying a mortgage broker more than the

[129] *Id.* at 1719.

[130] *Id.* at 1720. According to the National Association of Mortgage Brokers, in 2004 there were 53,000 mortgage brokerage companies that employed an estimated 418,700 people. The Board believes that most of these companies are small entities. In its comment letter, Advocacy noted that the appropriate SBA size standard for mortgage brokers is $6.5 million in average annual receipts and that, of 15,590 mortgage broker firms in the U.S. according to the 2002 Economic Census data, 15,195 would be classified as small using the $6.5 million standard.

[131] 73 FR 1672, 1719 (Jan. 9, 2008).

[132] *Id.* at 1720.

[133] *Id.* at 1717.

consumer had agreed in advance that the broker would receive. The Board is concerned that the proposed agreement and disclosures would confuse consumers and undermine their decision making rather than improve it. The Board will continue to explore available options to address potentially unfair acts or practices associated with originator compensation arrangements such as yield spread premiums.

Servicing. The proposed rule prohibited 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. Several commenters noted that the fee schedule disclosures would be very costly for a servicer since fees vary by state, county, city, investor and even product. The Board has considered the concerns raised by commenters and has concluded that the transparency benefit of the schedule does not sufficiently offset the burdens of producing such a schedule. Thus, the Board is not adopting the proposed fee schedule disclosure.

Early disclosures. The proposed rule would require creditors to give consumers transaction-specific, early mortgage loan disclosures for certain closed-end loans secured by a consumer's principal dwelling. The proposed rule would require creditors to deliver this disclosure within three business days of application and before a consumer pays a fee to any person, other than a fee for obtaining the consumer's credit report. Many creditors and their trade associations opposed the proposal due to operational cost and compliance difficulties (for example, system reprogramming, testing, procedural changes, and staff training). They noted that the burden may be significant for some small entity creditors, such as community banks.

The Board is adopting § 226.19(a)(1)(iii) substantially as proposed. The Board believes that alternatives to the final rule would not achieve TILA's objectives. However, as discussed below, the Board has chosen an implementation period for the final rule that responds to creditors' concerns about the time required to comply with the rule.

Effective date. The Board requested comment on whether six months would be an appropriate implementation period, and on the length of time necessary for creditors to implement the proposed rules, as well as whether the Board should specify a shorter implementation period for certain provisions in order to prevent unfair or deceptive practices.

Many industry commenters and their trade associations stated that six months would be an appropriate implementation period for some parts of the rule, but that they would need additional time to implement the proposed early mortgage loan disclosure requirement and the proposed escrow requirement. Commenters requested additional time to implement the early mortgage loan disclosure rule in order to provide sufficient time for system re-programming, testing, procedural changes, and staff training. And, although many creditors currently provide for escrows, other creditors, including many that are small entities, currently have no escrowing capacity or infrastructure. These commenters requested a period of 12 to 24 months to implement the necessary systems and processes. Manufactured housing industry commenters were particularly concerned because a limited infrastructure is in place for escrowing on manufactured housing loans.

In light of these concerns, the Board believes additional compliance time beyond six months is appropriate. With two exceptions, the final rule is effective for loans consummated on or after October 1, 2009. The requirement to establish an escrow account for taxes and insurance for higher-priced mortgage loans is effective for loans consummated on or after April 1, 2010, or, for loans secured by manufactured housing, consummated on or after October 1, 2010.

3. Description and Estimate of Small Entities To Which the Proposed Rule Would Apply

The final rule applies to all institutions and entities that engage in closed-end home-secured lending and servicing. The Board acknowledged in its IRFA the lack of a reliable source for the total number of small entities likely to be affected by the proposal, since 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.

Through data from Reports of Condition and Income ("call reports"), the Board identified approximate numbers of small depository institutions that would be subject to the proposed rules. Based on March 2008 call report data, approximately 8,393 small institutions would be subject to the final rule. Approximately 17,101 depository institutions in the United States filed call report data, approximately 12,237 of which had total domestic assets of $165 million or less and thus were considered small entities for purposes of the RFA. Of 4,554 banks, 401 thrifts and 7,318 credit unions that filed call report data and were considered small entities, 4,259 banks, 377 thrifts, and 3,757 credit unions, totaling 8,393 institutions, extended mortgage credit. For purposes of this analysis, thrifts include savings banks, savings and loan entities, co-operative banks and industrial banks.

In its IRFA, the Board recognized that it could not identify with certainty the number of small nondepository institutions that would be subject to the proposed rule. Home Mortgage Disclosure Act (HMDA) data indicate that 2,004 non-depository institutions filed HMDA reports in 2006. Based on the small volume of lending activity reported by these institutions, most are likely to be small.

Certain parts of the final rule would apply to mortgage brokers. The Board provided an estimate of the number of mortgage brokers in its IRFA, citing data from the National Association of Mortgage Brokers indicating that in 2004 there were 53,000 mortgage brokerage companies.[134] The Board estimated in the IRFA that most of these companies are small entities. A comment letter received by the U.S. Small Business Administration, citing the 2002 Economic Census, stated that there were 15,195 small mortgage broker entities.

Certain parts of the final rule would also apply to mortgage servicers. As noted in IRFA, 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 final rule and that are small as defined by the U.S. Small Business Administration.

4. Reporting, Recordkeeping, and Other Compliance Requirements

The compliance requirements of the final rule are described in the SUPPLEMENTARY INFORMATION. Some small entities will 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

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

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. For some small entities, certain parts of the rule may require the type of professional skills already necessary to meet other legal requirements. For example, the Board believes that final rule's requirements with regard to advertising will require the same types of professional skills and recordkeeping procedures that are needed to comply with existing TILA and Regulation Z advertising rules. Other parts of the rule may require new professional skills and recordkeeping procedures for some small entities. For example, creditors that do not currently offer escrow accounts will need to implement that capability. The Board believes that costs of the final rule as a whole will have a significant economic effect on small entities.

5. Steps Taken To Minimize the Economic Impact On Small Entities

The steps the Board has taken to minimize the economic impact and compliance burden on small entities, including the factual, policy, and legal reasons for selecting the alternatives adopted and why each one of the other significant alternatives was not accepted, are described above in the **SUPPLEMENTARY INFORMATION** and in the summary of issues raised by the public comments in response to the proposal's IRFA. The final rule's modifications from the proposed rule that minimize economic impact on small entities are summarized below.

First, the Board has provided a different standard for defining higher-priced mortgage loans to more accurately correspond to mortgage market conditions and exclude from the definition some prime loans that might have been classified as higher-priced under the proposed rule. The Board believes that this will decrease the economic impact of the final rule on small entities by limiting their compliance costs for prime loans the Board does not intend to cover under the higher-priced mortgage loan rules.

Second, the Board is providing an implementation period that responds to commenters' concerns about the time needed to comply with the final rule. The Board is also providing later effective dates for the escrow requirement than for the other parts of the final rule. As discussed above, the Board believes that these effective dates will decrease costs for small entities by providing them with sufficient time to come into compliance with the final rule's requirements.

The Board also notes that it is withdrawing two proposed rules for which small entity commenters expressed concern about the costs of compliance. The Board is withdrawing its proposal to prohibit creditors from paying a mortgage broker more than the consumer had agreed in advance that the broker would receive, and its proposal to 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.

The Board believes that these changes minimize the significant economic impact on small entities while still meeting the stated objectives of HOEPA and TILA.

List of Subjects in 12 CFR Part 226

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

Authority and Issuance

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

PART 226—TRUTH IN LENDING (REGULATION Z)

■ 1. The authority citation for part 226 is amended to read as follows:

Authority: 12 U.S.C. 3806; 15 U.S.C. 1604, 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) * * *

* * * * *

(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.

* * * * *

■ 3. Section 226.2 is amended by revising paragraph (a)(6) to read as follows:

§ 226.2 Definitions and Rules of Construction.

(a) * * *

(6) *''Business Day''* means a day on which the creditor's offices are open to the public for carrying on substantially all of its business functions. However, for purposes of rescission under §§ 226.15 and 226.23, and for purposes of § 226.19(a)(1)(ii) and § 226.31, the term means all calendar days except Sundays and the legal public holidays specified in 5 U.S.C. 6103(a), such as New Year's Day, the Birthday of Martin Luther King, Jr., Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veterans Day, Thanksgiving Day, and Christmas Day.

Subpart B—Open-End Credit

■ 4. Section 226.16 is amended by revising paragraphs (d)(2) through (d)(4), and adding new paragraphs (d)(6) and (e) to read as follows:

§ 226.16 Advertising.

* * * * *

(d) *Additional requirements for home-equity plans*

* * * * *

(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) The period of time such initial rate will be in effect; and

(ii) 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 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 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

[36e] [Reserved.]

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 advertisement states that the advertised extension of credit may 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) *Promotional rates and payments*—(i) *Definitions.* The following definitions apply for purposes of paragraph (d)(6) of this section:

(A) *Promotional rate.* The term ''promotional 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) *Promotional payment.* The term ''promotional payment'' means—

(*1*) For a variable-rate plan, any minimum payment applicable for a promotional 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 minimum payments under the plan; and

(*ii*) Is less than other minimum 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 minimum payment applicable for a promotional period if that payment is less than other payments required under the plan given an assumed balance.

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

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

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

(B) In the case of a promotional 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 a promotional payment, the amounts 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 shall be disclosed based on a reasonably current index and margin.

(iii) *Envelope excluded.* The requirements in paragraph (d)(6)(ii) 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.

(e) *Alternative disclosures—television or radio advertisements.* An advertisement for a home-equity plan subject to the requirements of § 226.5b made through television or radio stating any of the terms requiring additional disclosures under paragraph (b) or (d)(1) of this section may alternatively comply with paragraph (b) or (d)(1) of this section by stating the information required by paragraph (b)(2) of this section or paragraph (d)(1)(ii) of this section, as applicable, and listing a toll-free telephone number, or any telephone number that allows a consumer to reverse the phone charges when calling for information, along with a reference that such number may be used by consumers to obtain additional cost information.

Subpart C—Closed-End Credit

■ 5. Section 226.17 is amended by revising paragraphs (b) and (f) 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 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]

* * * * *

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

§ 226.19 Certain mortgage and variable-rate transactions.

(a) *Mortgage transactions subject to RESPA*—(1)(i) *Time of disclosures.* In a 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

[39] [Reserved.]

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 history before the consumer has received the disclosures required by paragraph (a)(1)(i) of this section, provided the fee is *bona fide* and reasonable in amount.

* * * * *

■ 7. Section 226.23 is amended by revising footnote 48 to paragraph (a)(3) to read ''The term 'material disclosures' means the required disclosures of the annual percentage rate, the finance charge, the amount financed, the total of payments, the payment schedule, and the disclosures and limitations referred to in §§ 226.32(c) and (d) and 226.35(b)(2).''

■ 8. Section 226.24 is amended by redesignating paragraphs (b) through (d) as paragraphs (c) through (e), respectively, adding new paragraph (b), revising newly designated paragraphs (c) through (e), removing and reserving footnote 49, and adding new paragraphs (f) through (i), to read as follows:

§ 226.24 Advertising.

* * * * *

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

(c) *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, the 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) *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)(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)(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) *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)(2) of this section, it shall be considered a single advertisement if—

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

(ii) Any statement of the credit terms in paragraph (d)(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)(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

[49] [Reserved.]

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 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 clearly and conspicuously each of the additional disclosures required under paragraph (d)(2) of this section; or

(2) Stating clearly and conspicuously the information required by paragraph (d)(2)(iii) of this section and listing a toll-free telephone number, or any telephone number that allows a consumer to reverse the phone charges when calling for information, 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 advertisement states that the advertised extension of credit may 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 payment will increase, unless:

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

(A) The phrase ''Adjustable-Rate Mortgage,'' ''Variable-Rate Mortgage,'' or ''ARM'' appears in the advertisement before the first use of the word ''fixed'' and is at least as conspicuous as any 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 non-variable-rate transactions where the payment will increase (*e.g.*, a stepped-rate mortgage transaction with an initial lower payment), each use of the word ''fixed'' to refer to the 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 will 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 actual or hypothetical credit payments or rates and any payment or simple annual rate that will be available under the advertised product for a period less than the full term of the loan, unless:

(i) *In general.* The advertisement includes a clear and conspicuous comparison to the information required to be disclosed under sections 226.24(f)(2) and (3); and

(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 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.

(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 misleading 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 use of the term ''counselor''.* Using the term ''counselor'' in an advertisement to refer to a for-profit mortgage broker or mortgage creditor, its employees, or persons working for the broker or creditor 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

■ 9. Section 226.32 is amended by revising paragraphs (d)(6) and (d)(7) to read as follows:

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§ 226.32 Requirements for certain closed-end home mortgages.

* * * * *

(d) * * *

(6) *Prepayment penalties.* Except as allowed under paragraph (d)(7) of this section, a penalty for paying all or part of the principal before the date on which the principal is due. A prepayment penalty includes computing a refund of unearned interest by a method that is less favorable to the consumer than the actuarial method, as defined by section 933(d) of the Housing and Community Development Act of 1992, 15 U.S.C. 1615(d).

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

(i) The penalty will not apply after the two-year period following consummation;

(ii) The penalty will not apply if the source of the prepayment funds is a refinancing by the creditor or an affiliate of the creditor;

(iii) At consummation, the consumer's total monthly debt payments (including amounts owed under the mortgage) do not exceed 50 percent of the consumer's monthly gross income, as verified in accordance with § 226.34(a)(4)(ii); and

(iv) The amount of the periodic payment of principal or interest or both may not change during the four-year period following consummation.

* * * * *

■ 10. 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 subject to § 226.32.

(a) * * *

(4) *Repayment ability.* Extend credit subject to § 226.32 to a consumer based on the value of the consumer's collateral without regard to the consumer's repayment ability as of consummation, including the consumer's current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations.

(i) *Mortgage-related obligations.* For purposes of this paragraph (a)(4), mortgage-related obligations are expected property taxes, premiums for mortgage-related insurance required by the creditor as set forth in § 226.35(b)(3)(i), and similar expenses.

(ii) *Verification of repayment ability.* Under this paragraph (a)(4) a creditor must verify the consumer's repayment ability as follows:

(A) A creditor must verify amounts of income or assets that it relies on to determine repayment ability, including expected income or assets, 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.

(B) Notwithstanding paragraph (a)(4)(ii)(A), a creditor has not violated paragraph (a)(4)(ii) if the amounts of income and assets that the creditor relied upon in determining repayment ability are not materially greater than the amounts of the consumer's income or assets that the creditor could have verified pursuant to paragraph (a)(4)(ii)(A) at the time the loan was consummated.

(C) A creditor must verify the consumer's current obligations.

(iii) *Presumption of compliance.* A creditor is presumed to have complied with this paragraph (a)(4) with respect to a transaction if the creditor:

(A) Verifies the consumer's repayment ability as provided in paragraph (a)(4)(ii);

(B) Determines the consumer's repayment ability using the largest payment of principal and interest scheduled in the first seven years following consummation and taking into account current obligations and mortgage-related obligations as defined in paragraph (a)(4)(i); and

(C) Assesses the consumer's repayment ability taking into account at least one of the following: The ratio of total debt obligations to income, or the income the consumer will have after paying debt obligations.

(iv) *Exclusions from presumption of compliance.* Notwithstanding the previous paragraph, no presumption of compliance is available for a transaction for which:

(A) The regular periodic payments for the first seven years would cause the principal balance to increase; or

(B) The term of the loan is less than seven years and the regular periodic payments when aggregated do not fully amortize the outstanding principal balance.

(v) *Exemption.* 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.

* * * * *

■ 11. 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 secured by the consumer's principal dwelling with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set by 1.5 or more percentage points for loans secured by a first lien on a dwelling, or by 3.5 or more percentage points for loans secured by a subordinate lien on a dwelling.

(2) ''Average prime offer rate'' means an annual percentage rate that is derived from average interest rates, points, and other loan pricing terms currently offered to consumers by a representative sample of creditors for mortgage transactions that have low-risk pricing characteristics. The Board publishes average prime offer rates for a broad range of types of transactions in a table updated at least weekly as well as the methodology the Board uses to derive these rates.

(3) Notwithstanding paragraph (a)(1) of this section, the term ''higher-priced mortgage loan'' does not include 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 extend credit based on the value of the consumer's collateral without regard to the consumer's repayment ability as of consummation as provided in § 226.34(a)(4).

(2) *Prepayment penalties.* A loan may not include a penalty described by § 226.32(d)(6) unless:

(i) The penalty is otherwise permitted by law, including § 226.32(d)(7) if the loan is a mortgage transaction described in § 226.32(a); and

(ii) Under the terms of the loan—

(A) The penalty will not apply after the two-year period following consummation;

(B) The penalty will not apply if the source of the prepayment funds is a refinancing by the creditor or an affiliate of the creditor; and

(C) The amount of the periodic payment of principal or interest or both may not change during the four-year period following consummation.

(3) *Escrows*—(i) *Failure to escrow for property taxes and insurance.* Except as provided in paragraph (b)(3)(ii) of this section, a creditor may not extend a loan secured by a first lien on a principal dwelling unless an escrow account is established before consummation for payment of property taxes and premiums for mortgage-related insurance required by the creditor, such as insurance against loss of or damage to property, or against liability arising out of the ownership or use of the property, or insurance protecting the creditor against the consumer's default or other credit loss.

(ii) *Exemptions for loans secured by shares in a cooperative and for certain condominium units*—(A) Escrow accounts need not be established for loans secured by shares in a cooperative; and

(B) Insurance premiums described in paragraph (b)(3)(i) of this section need not be included in escrow accounts for loans secured by condominium units, where the condominium association has an obligation to the condominium unit owners to maintain a master policy insuring condominium units.

(iii) *Cancellation.* A creditor or servicer may permit a consumer to cancel the escrow account required in paragraph (b)(3)(i) of this section only in response to a consumer's dated written request to cancel the escrow account that is received no earlier than 365 days after consummation.

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

(4) *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.

■ 12. 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) *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 for another person. 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.

(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 this paragraph (b)(1) 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) Excluding an appraiser from consideration for future engagement because the appraiser reports a value of a consumer's principal dwelling that does not meet or exceed a minimum threshold;

(C) Telling an appraiser a minimum reported value of a consumer's principal dwelling that is needed to approve the loan;

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

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

(ii) Examples of actions that do not violate this paragraph (b)(1) 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; and

(F) 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, at or before loan consummation, of a violation of paragraph (b)(1) of this section 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) *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 (c)(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 any applicable grace period; or

(iii) 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 that would be required to satisfy the consumer's 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 as of 5 days after receipt.

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

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