

## **Board of Governors of the Federal Reserve System; Truth in Lending**

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Adopted:                July 14, 2008

Effective Date:        October 1, 2009: All provisions, except the escrow rules  
                              April 1, 2010:    Escrow requirements for first-lien higher-priced loans and HOEPA-covered loans  
                              October 1, 2010: Escrow requirements for manufactured homes

On July 14, 2008, the Board of Governors of the Federal Reserve System issued amendments to Regulation Z that provide additional consumer protections for mortgage and home-equity loans. Part of the regulations are intended to prevent unscrupulous subprime lending, while other sections apply to all loans secured by a consumer's principal dwelling. As a result, all mortgage lenders will need to determine whether their existing lending policies and procedures need to be revised in order to comply with the new rules.

In summary, the regulation:

- Provides additional protections for "higher-priced" mortgage loans, including a requirement that lenders evaluate a borrower's ability to repay the loan.
- Prohibits lenders and brokers from coercing a real estate appraiser to misstate a home's value.
- Prohibits certain mortgage servicing practices.
- Requires additional disclosure information about loan rates, monthly payments, and other features. The amendments would also ban seven deceptive or misleading advertising practices.
- Requires creditors to provide a good faith estimate of the loan costs within three days after a consumer applies for a loan that will be secured by a consumer's principal dwelling, including a home improvement loan or a loan to refinance a consumer's existing loan.

Below is a summary of the new requirements. In the coming weeks, ABA will publish an ABAWorks on the new regulations and will host a teleconference in order to brief bankers about the new requirements. The ABAWorks will feature an in-depth analysis of the regulation, as well as practical tools to help banks ensure that their loans comply with the new regulations. ABA members will be able to access the ABAWorks free of charge.

## “Higher-priced” Mortgage Loans

- I. **Generally.** The regulation provides additional consumer protections to certain consumer residential mortgage loans, referred to as “higher-priced loans.”
- II. **Definition of a higher-priced loan.**
  - A. Generally. A higher-priced loan is a consumer residential mortgage loan with an APR greater than 1.50% over the “average prime offer rate” for first liens and 3.50% over the average offer rate for subordinate liens.
    1. The Federal Reserve will use the Freddie Mac Primary Mortgage Market Survey (PMMS) in order to estimate the average prime offer rate, and will adjust the offer rate in the PMMS to reflect points as reported in the survey. The Federal Reserve will estimate and publish the APR rates for loan products that are not included in the PMMS. The Federal Reserve has developed a method for these estimations and is requesting public comment on these proposed calculations. Comments will be due August 29, 2008.
  - B. Loans covered by the definition. Home purchase loans, home-improvement loans, refinancings, and home equity loans.
  - C. Loans not covered. Home equity lines of credit, reverse mortgages, construction-only loans, bridge loans, loans that lack primarily a consumer purpose (i.e., investment loans).
  - D. Comparison to Regulation C (HMDA). The Federal Reserve is separately proposing to revise Regulation C’s rules for reporting loan pricing on higher-priced loans in order to be consistent with the newly issued regulations under Regulation Z. Comments on the proposed revisions to Regulation C are due August 29, 2008.
  - E. Analysis. The Federal Reserve adopted the ABA’s recommendation that higher-priced loans be based on an index that tracks mortgage rates, not Treasury securities. Since the final rule lowered the spread when it shifted to an index based on market prices for mortgages, it is unclear, at this early stage, the extent to which the 1.50% threshold might inadvertently capture a portion of the prime market. Federal Reserve staff has acknowledged, however, that some prime loans, and especially prime jumbo loans, may be captured by the definition of higher-priced loan if disruptions in the mortgage market continue. Also, some Alt-A mortgages likely will become classified as higher-priced loans. Despite these concerns, the proposed rule is a clear improvement over the proposal, which would have had a much larger impact on prime and Alt-A lending. For instance, based on the July 11, 2008 PMMS, the final rule would set the threshold for 30-year fixed rate mortgages about 40 basis points higher than the initially proposed spread over Treasury rates.
- III. **Ability to repay.** Creditors would be prohibited from making higher-priced mortgage loans based on collateral without regard to a consumer’s repayment ability, including the consumer’s current and reasonably expected income, current

and reasonably expected obligations, employment, and assets other than the collateral.

- A. As of consummation. The creditor is responsible for assessing repayment ability as of consummation. A violation is not established if a borrower defaults because of significant expenses or income loss after consummation. The Federal Reserve stated in the preamble to the regulation that a default does not create a presumption of a violation of the ability to repay requirement.
- B. Income, assets, and employment. Lenders may look to a consumer's current and reasonably expected income, employment, and assets other than the collateral in order to determine repayment ability. The regulation provides broad flexibility and gives many examples of the types of income, assets, and employment on which a creditor may rely.
- C. Obligations. A creditor must consider the consumer's current obligations as well as mortgage-related obligations (i.e., taxes and insurance). The final rule eliminates the proposed rule's requirement to consider a consumer's "expected obligations."
- D. Third-party documents. Creditors must use third-party documents to verify assets or income, including expected income, that the creditor relies on in extending credit. Examples include W-2s, tax forms, payroll receipts, check-cashing receipts, remittance receipts, etc. The documentation provision is intended to be flexible. The one type of document that is excluded is a statement only from the consumer regarding the consumer's assets and income.
- E. Presumption of Compliance. The final regulation removes the proposed "pattern or practice" standard for determining an originator's civil liability for failure to consider a borrower's ability to repay a mortgage loan. Instead, the rule provides that a creditor is presumed to have complied with the ability to repay requirement by completing all of the following steps:
  - 1. Verify and document the consumer's repayment ability.
  - 2. Determine the consumer's ability to make loan payments based on a fully-indexed rate and fully-amortizing payment (except in certain circumstances) that includes property taxes, HOA dues, homeowner's insurance, and mortgage insurance premiums.
    - a. The relevant payment for underwriting is the largest payment that the consumer will have in seven years. Creditors may use a lower payment, but there would not be a presumption of compliance. Instead, compliance with the ability to repay requirement would be based on all of the facts and circumstances.
    - b. There is no presumption of compliance for a balloon payment with a term less than seven years.
    - c. If the term of the loan is at least seven years, the creditor may retain the presumption of compliance if it underwrites based on regular payments (not the balloon payment).

- d. Loans with negative amortization within the first seven years are excluded from the presumption of compliance.
    - e. Interest-only loans can have a presumption of compliance.
  - 3. Assess the consumer's ability to repay using either a debt-to-income ratio or the income the consumer will have after paying debt obligations. The rule does not provide quantitative thresholds for either of these metrics.
- F. Rebuttable Presumption of Compliance. Significantly, a borrower may rebut the presumption of compliance with evidence that the creditor disregarded repayment ability even though the creditor adhered to the steps described above. 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.
- G. Automated Underwriting System. The Federal Reserve declined to adopt a safe harbor for a loan approved by the automated underwriting system of the GSEs or of any federally-regulated institution.

- IV. **Prepayment penalties.** The regulation imposes the following restrictions on prepayment penalties:
  - A. If loan payments can change on a higher-priced mortgage loan or a HOEPA loan within the first four years: prepayment penalties are prohibited.
  - B. If payments on higher-priced loan and a HOEPA loan cannot change for the first four years:
    - 1. The prepayment penalty is prohibited for two years after consummation.
    - 2. The prepayment penalty is prohibited if the same creditor or its affiliate makes the refinance loan.
  - C. For HOEPA loans only, the final rule retains the current prohibition of penalty provisions for loans with a debt-to-income ratio exceeding 50%.
- V. **Escrow accounts for taxes and insurance.** Higher-priced loans secured by a first lien are required to have an escrow account for property taxes and homeowners insurance.
  - A. Borrowers can opt out of the escrow account after first twelve months.
  - B. Payment amounts in advertisements that do not include taxes and insurance must disclose that fact in close proximity to the payment amount.
- VI. **Evasion.** Creditors are prohibited from structuring a closed-end mortgage loan as an open-end line of credit in order to avoid the additional protections provided to higher-priced mortgage loans, which would not apply to open-end lines of credit.

## **Proposed Rules for All Mortgage Loans**

- I. **Creditor payments to mortgage brokers.**

- A. Broker Compensation Provisions Withdrawn. The final rule withdraws the proposed broker disclosure requirement because the Federal Reserve conducted consumer testing which showed that the proposed broker disclosure would lead to consumer confusion. The Federal Reserve indicates that it will explore other options for addressing broker compensation issues.
1. Proposal. The proposed rule would have required mortgage brokers to disclose, in writing, in advance, any compensation that the broker would receive from the consumer, and to obtain the consumer's written agreement to such a compensation structure. Brokers would have been prohibited from receiving more than the consumer agreed to pay. The disclosure would have stated that the consumer ultimately bears the cost of all of the broker's compensation (even if the creditor paid part of it directly) and that the creditor's payment to the broker could influence the choice of terms or products that the broker offered.
- B. ABA Position. ABA supported the proposed broker disclosure requirements, arguing that consumers should receive information that is specific about a broker's role and compensation in a mortgage transaction. However, ABA urged the Federal Reserve to adopt new broker disclosure rules in conjunction with HUD's revision to the RESPA rules.

## II. **Coercion of appraisers.**

- A. Generally. The new regulation prohibits creditors and mortgage brokers from:
1. Coercing, influencing, or otherwise encouraging an appraiser to misstate the value of a consumer's principal dwelling; and
  2. Extending credit based on an appraisal when the creditor knows that prohibited conduct has occurred.
- B. Illustrative Examples. The Federal Reserve does not specifically define the terms "coerce, influence, or otherwise encourage." Instead, such acts are clarified by way of illustrative examples. For example, "pressure" or "coercion" would include:
1. Implying that retention of the appraiser depends on the amount at which the appraiser values the property.
  2. Failing to compensate or retain an appraiser in the future because the appraisal comes in too low.
  3. Conditioning compensation on the loan closing.
- C. Materiality. The commentary to the regulation clarifies 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.
- D. Legal authority. The Federal Reserve adopts the appraisal provision pursuant to the broad statutory authority delineated under TILA section 129(1)(2), which allows for the adoption of regulations that address unfair or deceptive acts or practices in connection with mortgage loans.
- E. ABA Position. In its comments to the Federal Reserve, ABA expressed concern about a proposed standard that would have rendered a lender liable in instances where they "know" or had "reason to know" that a broker

improperly influenced an appraiser in connection with an extension of credit. In the final rule, the Federal Reserve notes this concern and deleted the “reason to know” test.

- III. Servicing abuses.** The regulation prohibits the following servicing practices:
- A. Failing to credit payments as of the day that they are received unless:
    - 1. A delay in crediting does not result in a finance or other charge or in the reporting of negative information to a reporting agency.
  - B. Imposing a late fee on a consumer for making an otherwise timely payment that would be the full amount currently due, but for the payment’s failure to include a previously assessed late fee (aka pyramiding fees).
  - C. Failing to provide an accurate statement of payoff within a reasonable time after the request.
  - D. The Federal Reserve did not adopt the proposed requirement that would have prohibited a servicer from failing to provide a fee schedule to the consumer upon request.

## **Advertising Rules for Open-End Home-Equity Plans**

- I. Discounted and premium rates.** An advertisement for a variable-rate home-equity plan that states an initial APR that is not based on the index and margin that will be used to make later rate adjustments must also state the period of time that the initial rate will be in effect and a reasonably current APR that would have been in effect using the index and margin. These disclosures must be stated with equal prominence and in close proximity to the statement of the initial APR.
- II. Introductory rates and payments.** The rule requires additional disclosures for advertisements of open-end home equity loans with promotional rates and payments. Such advertisements must:
- A. Use the term “promotional” in immediate proximity to each mention of the introductory rate or payment.
  - B. Disclose the following information in a clear and conspicuous manner with each listing of the promotional rate or payment:
    - 1. The period of time during which the promotional rate or promotional payment will apply.
    - 2. For a promotional rate, any APR that will apply under the plan.
    - 3. For a promotional payment, the amount and time periods of any payments that will apply under the plan.
    - 4. For variable rate transactions, payments that are based on a reasonably current index and margin.
  - C. Exceptions and alternative disclosures would apply for certain types of media (e.g., banner and television advertisements).
- III. Clear and conspicuous standard.** The regulation specifies how the “clear and conspicuous standard” would apply to advertisements for home-equity plans with

introductory rates or payments, and to Internet, television, and oral advertisements of home-equity plans.

- IV. Balloon payment.** Advertisements that include information about minimum periodic payments are required to state (if applicable) that a balloon payment may result. Balloon payment disclosures must be equally prominent and in close proximity to the statement of a minimum periodic payment. The final rule clarifies 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. Additionally, the final rule clarifies 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 pay the outstanding balance at such time.
- V. Tax implications.** Open-end home equity advertisements must state that if the amount of the loan exceeds the fair market value of the dwelling, 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. The advertisement must include a statement that consumers should consult a tax adviser for further information regarding the deductibility of interest and charges. The final rule requires that the additional tax 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 may occur.

## **Advertising Rules for Closed-End Credit**

- I. Clear and conspicuous standard.** The regulation clarifies how the clear and conspicuous standard applies to rates or payments in advertisements for home-secured loans.
- II. Advertisement of rates and payments.** The amendments are intended to disclose all rates or payments that will apply over the term of the loan as well as the time periods for which those rates or payments will apply.
- A. **Generally.** Advertisements cannot 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.
- B. **Buydowns.** Additional disclosures are required when an advertisement includes information showing the effect of the buydown agreement on the payment schedule.
- C. **Discounted variable-rate transactions.** An advertisement for a discounted variable-rate transaction that advertises a reduced or discounted simple annual rate must show the limited term to which the simple annual rate applies and the APR that will apply after the term of the initial rate expires.

- D. Disclosure of all rates. An advertisement that states a simple annual rate of interest when more than one simple annual rate of interest will apply over the term of the advertised loan must clearly and conspicuously disclose:
  - 1. Each simple annual rate of interest.
  - 2. The period of time during which each simple annual rate of interest will apply.
  - 3. The APR for the loan.
- E. Disclosure of all payments. An advertisement that states the amount of any payment must disclose:
  - 1. Payments that will apply over the term of the loan (including any balloon payment if the consumer makes only the minimum payments specified in an advertisement), not just the repayment terms that will apply for a limited time.
  - 2. The period of time during which each payment will apply.
  - 3. The fact that the payments do not include amounts for taxes and insurance premiums, if applicable. This requirement applies only to first liens.
- F. Exceptions. The proposal would allow alternative disclosures for television and radio advertisements for information provided orally. The final rule is amended to also provide alternative disclosures for information provided in visual text in television advertisements.

**III. Prohibition on certain acts or practices.** The regulation prohibits the following practices:

- A. Using the word “fixed” to refer to rates or payments when the rate or payment would be “fixed” for a limited time.
- B. Comparing a consumer’s actual or hypothetical current payments or rates and any payment that would apply if the consumer obtains the advertised loan unless the advertisement includes:
  - 1. A comparison to all applicable payments or rates for the advertised product that will occur over the term of the loan; and
  - 2. A statement that the advertised payments do not include amounts for taxes and insurance, if applicable.
- C. Advertising a product as being endorsed or sponsored by a governmental entity, unless the advertisement is for an FHA, VA, or similar loan program that is endorsed or sponsored by a federal, state or local government entity.
- D. Displaying the name of the consumer’s current lender in an advertisement unless the ad also prominently discloses that it is not associated with the customer’s current lender.
- E. Claiming that the advertised product will eliminate debt or result in a waiver or forgiveness of a consumer’s existing loan obligations with another creditor.
- F. Giving the false impression that a broker or lender has a fiduciary relationship with the borrower.
- G. Providing information about trigger terms or required disclosures only in a foreign language, but providing other trigger terms or required disclosures only in English in the same advertisement.

- IV. Tax implications.** The rule requires that 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.

## **Mortgage Loan Disclosures**

- I. Generally.** Creditors must provide a good faith estimate of loan costs within three days after a consumer applies for a mortgage loan that is secured by a consumer's dwelling.
- A. Lenders cannot charge consumers any fee until they receive the early disclosures, except a reasonable fee for obtaining a credit report.
  - B. The early disclosures that consumers will receive under this provision include: a payment schedule (which will illustrate any increases in payments over time resulting from variable terms), the total payments, the finance charge, the amount financed, and the APR (that reflects the fully indexed rate in cases of hybrid and payment-option ARMs).
  - C. For purposes of charging the fee, creditors may presume that the consumer receives the early mortgage loan disclosure three days after the disclosure is mailed. The final rule applies to all closed-end loans secured by a consumer's principal dwelling.