Board of Governors of the Federal Reserve System
Department of Housing and Urban Development

Joint Report to the Congress Concerning Reform to the Truth and Lending Act and the Real Estate Settlement Procedures Act

July 1998

EXECUTIVE SUMMARY

Section 2101 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996[1] directed the Board of Governors of the Federal Reserve System (the Board) and the Department of Housing and Urban Development (HUD) to simplify and improve the disclosures given in transactions subject to the Truth in Lending Act (TILA)[2] and the Real Estate Settlement Procedures Act (RESPA),[3] including the timing for providing those disclosures. The agencies were also asked to create a single TILA-RESPA disclosure statement, if feasible, that would meet the purposes of the acts. These changes were to be made by regulation, if possible; if statutory amendments were necessary, the Board and HUD were to make legislative recommendations. In 1997, the agencies concluded that meaningful change could come only through legislation. This report presents the Board's and HUD's recommendations for revising TILA and RESPA.

The report discusses various ways of streamlining and simplifying the current statutory requirements for mortgage loans, to provide consumers with more meaningful cost information about home-secured transactions and to make compliance easier for creditors.[4] It analyzes major policy questions and its focus and language are broad. The report does not explore all the details that must be addressed in making changes to TILA and RESPA, statutes with highly technical requirements in some instances. The recommendations and illustrative disclosure forms are a starting point for congressional consideration; they do not change any existing regulatory requirements.

TILA and RESPA differ in some fundamental ways but have a common purpose: to ensure that consumers obtain standardized cost information about mortgage loans. This information is meant to assist consumers when they shop for and enter into mortgage loan transactions. TILA seeks to promote the informed use of credit through standardized disclosures that reflect the cost of credit over the life of a loan and highlight certain credit terms.[5] To aid consumers in understanding the cost of credit, TILA requires the disclosure of two key terms--the finance charge and the annual percentage rate (APR). The finance charge reflects the dollar amount of the cost of credit and includes interest and other costs such as origination fees, discount points, and private mortgage insurance. The APR for closed-end credit is the finance charge expressed as an annualized rate that can be used to equate mathematically the stream of payments made over the life of the loan to its present value.

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[1] Pub. L. No. 104-208, 110 Stat. 3009.

[2] 15 U.S.C. § 1601 (1994 & Supp. II 1996).

[3] 12 U.S.C. § 2601 (1994 & Supp. II 1996).

[4] This report focuses on closed-end mortgage loans, whether first or subordinate liens. The impact of reform could be much broader. For example, TILA and RESPA also address home-secured open-end credit plans. Further, any revisions to TILA, whether adjusting the components of the finance charge or eliminating other disclosures, could affect all consumer credit transactions.

[5] TILA governs all types of consumer credit transactions, including credit cards and other lines of credit, unsecured installment loans, and home-secured loans.

Besides disclosures, TILA includes some substantive prohibitions (such as restrictions on certain balloon payments) and other consumer protections (such as the right to cancel certain home-secured loans). TILA is implemented by the Board's Regulation Z.[6]

RESPA seeks to protect consumers from unnecessarily high real estate settlement costs by providing them with information about the costs required to close a mortgage loan transaction and by prohibiting certain business practices. The two key RESPA disclosures are the good faith estimate of settlement costs (the GFE) and the settlement statement (the HUD-1 and HUD-1A). The GFE provides consumers with an itemized estimate of the costs the consumer will pay at closing,[7] and the HUD-1 settlement statement records the actual costs paid, such as fees for survey, appraisal, credit report, title examination and insurance, loan points, mortgage broker fees, and amounts to be held in reserve accounts. Under § 8, RESPA prohibits kickbacks, referral fees, and unearned fees because of the Congress's finding that these practices unnecessarily increase the cost of settlement services to consumers. RESPA is implemented by HUD's Regulation X.[8]

For consumers, the current TILA and RESPA disclosure rules may fall short of meeting their intended goals. Frequently, consumers must pay a fee before receiving the required disclosures, and then may receive them too late to find them helpful in comparison shopping. Consumers may also discover that the cost estimates they receive under RESPA differ significantly from the final figures and they have no federal remedy to address inaccuracies. They may find that certain cost information in the TILA disclosures--such as the APR and the amount financed--is not readily understandable. In addition, abusive lending practices targeting consumers persist, and the current laws offer limited protections and remedies.

For creditors and other settlement service providers, the TILA and RESPA rules can be complicated and may pose liability risks.[9] Under TILA, creditors may be subject to substantial liability in class action lawsuits for misclassifying some fees used to calculate the finance charge and the APR. Amendments to TILA have substantially reduced creditors' potential liability, but compliance nonetheless remains burdensome. Under RESPA, creditors

[6] 12 C.F.R. Pt. 226 (1998).

[7] As used in this summary, "closing" refers to either consummation or settlement, as applicable under TILA or RESPA, respectively. TILA defines consummation as the time that a consumer becomes contractually obligated on a credit transaction, as determined by state law. RESPA defines settlement as the time that the consumer executes legally binding documents regarding a lien on property subject to a federally related mortgage loan.

[8] 24 C.F.R. Pt. 3500 (1997).

[9] As used in this report, "creditor" refers to an entity that originates mortgage loans and is covered by either TILA or RESPA. Under TILA, the term "creditor" means a person who regularly extends credit and to whom the obligation is made payable. RESPA uses the term "lender," which generally has the same meaning as "creditor" under TILA, but excludes certain mortgage brokers and dealers. (See 24 C.F.R. § 3500.2 (1997) for the complete definition of lender.)

For purposes of the report, the term "settlement services providers" generally refers to entities that provide services used in connection with real estate settlement, such as appraisers, title companies, and real estate brokers. Under RESPA, the term also includes mortgage loan originators.

may be subject to both civil and criminal penalties for violating the § 8 prohibitions against kickbacks, referral fees, and unearned fees, but the act does not provide specific guidance on what fees are or are not lawful. Some in the industry view these prohibitions as an impediment to operational efficiencies that could streamline the mortgage process to consumers' benefit. At the same time, others in the industry worry that eliminating or making exceptions to the prohibitions could adversely affect consumers and lead to the consolidation of the mortgage loan origination market into the hands of a few large companies.

MAJOR POLICY QUESTIONS AND SUMMARY OF THE AGENCIES' RECOMMENDATIONS

Interest in mortgage reform extends beyond the congressional mandate to simplify and combine the TILA and RESPA disclosures. Many consumer groups and large segments of the mortgage lending and settlement services industries believe more fundamental reform of the statutes is needed. In extensive meetings with these parties, the two agencies gained important insight into the current state of the mortgage loan origination industry, and explored the different perspectives on how TILA and RESPA revisions could improve the mortgage loan process.

Using the information gathered from meetings, surveys, focus groups, and public comment letters, the Board and HUD identified four policy questions as key issues in TILA-RESPA reform. These questions and the agencies' recommendations are summarized below. The agencies agree on most recommendations; for some issues, only one agency makes a recommendation (as in the case of HUD's recommendation on the conditions for an exemption from § 8 and the Board's recommendation on rescission). The agencies believe that, considered as a whole, the recommendations for changes to TILA and RESPA strike an appropriate balance among the competing concerns of consumers, creditors, and settlement service providers. These recommendations can form a starting point for congressional consideration of legislative changes to TILA and RESPA. The suggested statutory changes, if adopted, could provide consumers with better and firmer information about the costs associated with home-secured credit transactions and could provide creditors with clearer rules.

The recommendations under the four questions are followed by additional HUD recommendations and by HUD's "essential reform" package--which represents the minimum reforms that HUD believes the Congress should consider enacting.

Policy Question 1: Should the Finance Charge and APR Disclosures in TILA Be Eliminated, or Should They Be Modified and Retained?

The Board and HUD recommend that the finance charge and APR concepts be retained, and that the definition of the finance charge (which affects the APR) be expanded to include all costs the consumer is required to pay in order to close the loan, with limited exceptions. The interest rate on the note and a revised explanation of the APR should be added as disclosures so that consumers can better understand the distinction between the two rates. In addition, the TILA cost disclosure should be coordinated with the initial RESPA disclosure. HUD also recommends that the initial disclosure inform the consumer about the functions of mortgage loan originators[10] and the requirements for private mortgage insurance and escrow accounts.

Policy Question 2: Should Creditors Be Required to Provide Firmer Quotes for Closing Costs Disclosed Under RESPA?

The Board and HUD recommend that creditors be required to give consumers more reliable closing cost information to promote shopping and competition. Creditors should be given a choice between guaranteeing settlement costs and providing a GFE that is accurate within a specified tolerance. Creditors would be liable for noncompliance.

The Board and HUD recommend granting an exemption from § 8 of RESPA to those offering a package of settlement services at a guaranteed price. The agencies believe that any entity should be allowed to package settlement services. HUD believes that an exemption from § 8 should be available to creditors and others that meet appropriate conditions, including:

- Offering consumers a comprehensive package of the settlement services needed to close a loan;

- Providing consumers with a simple prescribed disclosure that gives the guaranteed maximum price for the package of services through closing; and

- Disclosing the rate and points offered to the consumer for the loan, with a guarantee that the rate and points will not increase, subject to prescribed conditions.[11]

Policy Question 3: Should the Timing Rules for Providing Cost Disclosures to Consumers Be Changed (and Should Creditors Be Required to Provide Disclosures Before Imposing Substantial Fees)?

The Board and HUD recommend that consumers be given cost disclosures for any home-secured loan as early as possible in the shopping process. The Board recommends that the initial disclosures be provided not later than three days after application.[12] HUD

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[10] HUD's proposed mortgage broker rule requires the disclosure of this type of information, and HUD believes that reform efforts should be equally protective of consumers' interests. 62 Fed. Reg. 53,912 (October 16, 1997).

[11] HUD is aware of promising proposals to provide consumers guaranteed rate and point information subject only to market changes in rates (where the rate and points are not locked) and verification of borrower-supplied information including the value of the collateral and the borrower's creditworthiness. HUD supports these and similar efforts because it regards both cost and rate information as necessary so that consumers can effectively shop for mortgages.

[12] References in the report to "three days" generally mean business days as defined by TILA and RESPA.

recommends that the initial disclosures be provided even earlier if possible, such as at the consumer's first contact with a creditor or other entity in the mortgage loan process, and before the consumer pays any significant fee to the creditor that might deter shopping. Where offers are guaranteed, timing requirements could be extended to allow the creditor or other entity to provide a complete offer. HUD also recommends that educational booklets be provided when the consumer first contacts a creditor, a real estate agent, or other settlement service provider.

In addition, the Board and HUD recommend that creditors should be required to redisclose significant changes in the APR or other material disclosures and to provide an accurate copy of the HUD-1 settlement statement three days prior to closing. For nonpurchase home-secured transactions, the Board recommends that consumers also receive a notice at that time of a pre-closing right to a refund that would substitute for the existing post-closing rescission period in most instances.[13]

Policy Question 4: Should Additional Substantive Consumer Protections Be Added to the Statutes?

The Board and HUD recommend that substantive protections be adopted that will target abusive lending practices without unduly interfering with the flow of credit, creating unnecessary creditor burden, or narrowing consumers' options in legitimate transactions. These protections should be included as part of any legislation enacted to simplify and reform TILA and RESPA, to ensure that all homeowners benefit from the statutory reform. Any new rules should be part of a multifaceted approach that also includes nonregulatory strategies, such as increases in counseling and education efforts and voluntary industry action. The report discusses three primary areas where legislative efforts might be focused: addressing specific abusive lending practices; enhancing private remedies and public law enforcement; and, improving the information available to consumers.

The Board and HUD specifically recommend:

- Extending restrictions on balloon payments in loans subject to the Home Ownership Equity Protection Act (HOEPA) beyond the current limitations or prohibiting them altogether for HOEPA loans (or possibly the highest-priced HOEPA loans);[14]

- Prohibiting the advance collection of lump-sum credit insurance premiums for HOEPA loans, so that consumers may pay premiums periodically with

[13] Under current law, consumers can rescind certain nonpurchase home-secured transactions up to three days after becoming obligated for the loan. The right would be retained when the disclosures provided three days prior to closing were inaccurate, or were not provided at all.

[14] HOEPA added provisions to TILA that require certain disclosures to be made and prohibits certain terms for loans with rates and fees above a specified amount.

their regular mortgage payments and so that termination of the loan automatically cancels both the coverage and any liability for future credit insurance payments; and

- Requiring certain minimum standards for the notice creditors must provide in home foreclosures, including a written notice explaining consumers' legal rights and how they may avoid foreclosure, the process that will be followed if they do not exercise those rights, and information about the availability of third-party credit counseling.

In addition, HUD recommends:

- Lowering HOEPA thresholds combined with prohibitions against loan flipping and other specific abusive practices including such measures as regulating the financing of closing costs, requiring creditors to take into account the consumer's capacity to repay, expanding the current restrictions on prepayment penalties, and providing new protections for home improvement borrowers claiming contractor nonperformance or malfeasance;

- Adopting new foreclosure prevention strategies that could, where appropriate, include pre-foreclosure counseling and establish new federal rights for consumers to cure delinquent loans and recover remaining equity through a private sale prior to foreclosure;

- Requiring education and pre-transaction counseling, where appropriate, for certain consumers;

- Imposing information collection and reporting requirements on certain creditors that make loans covered by HOEPA; and

- That the Congress consider establishing a federal "unfair and deceptive acts and practices" standard to provide a private remedy for transactions that are unfair or unconscionable.

In the event the Congress does not enact an exemption from § 8, HUD still believes an essential reform package should be enacted. The package would include: requirements for dissemination of educational materials earlier in the homebuying or mortgage shopping process; combining and simplifying the RESPA and TILA disclosures and coordinating their timing to the greatest extent feasible; disclosing additional information relating to functions of mortgage originators and requirements for escrow accounts and private mortgage insurance; requiring more accurate estimates of settlement costs; new remedies against inaccurate disclosures and other consumer protections; and appropriate protections against predatory lending.

DISCUSSION OF MAJOR POLICY QUESTIONS

The following section summarizes analyses by the Board and HUD of the four major policy questions; chapters 2 through 6 of the report present a more detailed discussion of these issues.

Policy Question 1: Should the Finance Charge and APR Disclosures in TILA Be Eliminated, or Should They Be Modified and Retained?

Before TILA, creditors could advertise a loan rate, such as 6 percent, and use any one of several methods--simple interest, add-on, or discount--to calculate the dollars charged to the consumer. As a result, all loans advertised at 6 percent might look the same, but their true costs could vary significantly. TILA remedied that situation by requiring creditors to use a uniform calculation to arrive at a benchmark rate, the APR, for disclosure.

In enacting TILA, the Congress chose to use a calculation that included not only the *interest* that consumers would pay over the life of the loan, but also other charges deemed a cost of credit, called finance charges. A finance charge is defined by TILA to be *any charge* payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. This includes interest, points, and service or transaction fees; it excludes costs paid in a comparable cash transaction--property taxes, for example. The idea behind the concept was to capture the *total cost* the consumer pays to get the loan.

In fact, however, the finance charge and the corresponding APR have never disclosed the total cost of credit. From the start, the Congress carved out a number of fees. Among the statutory exclusions from the definition of the finance charge are (1) some closing costs associated with real-estate-secured loans (appraisals, title insurance, and document preparation), (2) certain insurance premiums, if the cost and other disclosures are provided to the consumer (hazard insurance), and (3) fees paid to government officials to record security interests if they are itemized in the disclosure (mortgage recording fees). Over time, the Board too has followed this "some fees in, some fees out" structure for the finance charge in its implementation of TILA.[15]

In regard to improving and simplifying TILA, most of the attention has focused on two issues: (1) whether the APR should be retained as a benchmark of the overall cost of credit, and (2) whether the definition of a finance charge should be revised to include more (or fewer) costs. The *finance charge* is the dollar cost of borrowing; the *APR* is the dollar cost expressed as an annualized rate.

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[15] For example, in interpreting the statutory exemption for appraisals, the Board has excluded appraisal review fees from the finance charge.

Preserving the APR as a Benchmark

A single figure benchmark that is simple to use allows consumers to evaluate competing products more easily than if they must evaluate three interrelated costs such as interest, points, and closing costs. Although some critics of the APR suggest eliminating it, there is considerable support for preserving the APR to help consumers comparison shop.

The APR as a benchmark does, of course, have certain limitations. Although it provides a relative ranking of the cost of similar types of loans, it does not--and is not intended to--capture some of the factors that consumers weigh in determining the best alternative among loan options. For example, the APR cannot tell a consumer whether the best economic choice is to bear credit costs by paying interest over time in the rate or by paying points up-front; the answer may depend on how long the borrower intends to hold the loan.

In some respects the APR has never been fully tested to see how good a benchmark it can be, given the statutory and regulatory exclusions. However, if it were to more accurately tell consumers the overall cost of their transaction, the APR could play a more important role in helping consumers comparison shop. In addition, including the interest rate on the TILA disclosure--alongside the APR--could help consumers better understand the difference between the two.

Improving the Finance Charge

Under the "some fees in, some fees out" approach, when consumers get the finance charge and APR disclosures they get a piece of the loan price, but not the entire price tag. This approach also makes it complicated for creditors to determine whether a particular fee is a finance charge.[16] Creditors then worry that courts may interpret certain fees as being in the finance charge when they have not been including them.

The Congress addressed many concerns about liability for minor errors in the classification of finance charges with the Truth in Lending Act Amendments of 1995.[17] These amendments clarified the treatment of some real-estate-related fees and increased the existing tolerances for errors. The irony is that while the Congress recognized the inherent complexities of the "some fees in, some fees out" scheme and provided litigation relief, the Congress at the same time perpetuated the scheme by excluding even more fees from the finance charge (such as fees for preparing loan-related documents) and by adding in others even though they do not seem to squarely fit within the finance charge definition (such as mortgage broker fees).

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[16] In examinations of state member banks conducted by the Federal Reserve between 1991 and midyear 1997, the finance charge disclosure for closed-end credit was the most common violation of Regulation Z. Data from the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency indicate, on average, comparable experience.

[17] 15 U.S.C. § 1601 (Supp. II 1996).

There is broad agreement that TILA's "some fees in, some fees out" disclosure scheme for the finance charge and APR could be improved. There is also considerable debate about how to improve it. In its deliberations, the Board has been guided by the principles the Congress used in enacting TILA: (1) credit costs must be fully disclosed so that consumers know all the terms and are better able to decide which offer to accept; (2) the cost of credit should be stated in terms that consumers understand so that comparing costs among creditors is easy; and (3) the cost of credit from all creditors should be stated comprehensively and uniformly to promote comparison shopping and competition.

Defining the finance charge as "the costs the consumer is required to pay to get the credit" would eliminate most of the difficulties. Such a definition would reflect the purposes of TILA and provide creditors with a consistent basis for determining what is a finance charge. Under this approach, many fees now excluded from the finance charge would be captured--real estate closing costs, such as for appraisals, document preparation, and property title services; fees paid to public officials to record security interests; and other costs, as shown in Figure 1 on the next page.[18] Mortgage broker fees would continue to be included in the finance charge.

[18] Fees for optional services and costs that depend on consumer choices (such as premiums for owner's title insurance and hazard insurance) would continue to be excluded.

Figure 1. Highlights of How the Required-Cost Test Would Affect the Characterization of Costs as Finance Charges

Item	Current TILA	Required-cost test
Application fee	X	✓
Credit report	N	✓
Appraisal/survey	N	✓
Lender's inspection fee (pre-consummation)	N	✓
Pest inspection	N	✓
Tax/flood certification	N	✓
Document preparation (loan-related)	N	✓
Title Charges		
Settlement or closing fee	X	✓
Abstract or title search/title examination	N	✓
Title insurance/binder - lender's coverage	N	✓
Notary fees (for mortgage)	N	✓
Attorney's fees (lender)	X	✓
Government Recording and Transfer Charges		
Recording fees: mortgage, release	N	✓
State/city/county tax/stamps: mortgage	N	✓

A more detailed chart is in Appendix C of the report.

✓ treated as a finance charge
N excluded from the finance charge
X treatment depends on circumstances

Recommendation. The Board and HUD believe consumers will benefit from having a disclosure that includes the full cost of credit. Moreover, having a single figure benchmark--the APR--that is simple to use allows consumers to evaluate competing products with one variable. The Board and HUD recommend that the APR be retained as a benchmark and that the interest rate on the note be added as a new disclosure. Disclosing the two figures together, along with a revised explanation of the APR, should improve consumer understanding of the significance of the APR and make it more useful.

A more comprehensive definition of the finance charge under TILA would require significantly fewer judgment calls by creditors about whether a particular fee is a finance charge. The Board and HUD believe that the finance charge should be defined to include "the costs the consumer is required to pay to get the credit." Under this approach, creditors would have a clearer rule and reduce their liability concerns. The changes should also make the disclosures more useful for consumers by providing a more accurate and reliable measurement of the cost of credit.

Policy Question 2: Should Creditors Be Required to Provide Firmer Quotes for Closing Costs Disclosed Under RESPA?

RESPA requires creditors to list on the GFE all costs they anticipate the consumer will have to pay in connection with closing a loan. The GFE is provided to a consumer within three days after application. The settlement statement containing the actual costs is provided at closing and, upon the borrower's request, must be provided one day prior; but the early statement need not be complete or accurate. There are few incentives under RESPA for compliance with its disclosure requirements since there is no liability for errors on the GFE or the settlement statement. Therefore, from the creditor's standpoint, little (if anything) needs to be done to simplify or improve the disclosures.

From the consumer's perspective, however, much could be improved. Generally the costs disclosed on the GFE are close to the actual costs, but not always. Consumers report many instances in which the costs disclosed on the GFE were significantly lower than those actually charged at closing. They also report cases in which some fees charged at closing were completely left off the GFE. To the extent these discrepancies exist, they make the GFE unreliable as a shopping tool; consumers cannot effectively compare settlement service costs if they cannot rely on the costs that are initially disclosed.

The Board and HUD have considered a number of ways for making closing costs more reliable for consumers and believe that two methods--guaranteed costs (with the possibility of exemption relief from § 8 of RESPA) and a GFE with an accuracy standard such as a tolerance--offer a feasible approach for improving the shopping disclosures that consumers receive while minimizing creditors' compliance burden.

Guaranteed Closing Costs

Under a guaranteed-cost approach, the creditor or other packager would set a lump-sum price for most of the closing costs and would be held to this figure. With some exceptions, most fees that consumers are required to pay to obtain a loan--such as fees for appraisals, title work, preparing and recording documents, inspections, and mortgage insurance--would have to be included in the guaranteed package of settlement services.[19] The creditor could arrive at the guaranteed amount by any method it chose. For example, the creditor could review its settlement statements for preceding periods and base the guaranteed price on an analysis of past transactions, current trends in the market, and fees charged by its service providers. Or the creditor might enter into contracts with service providers for set prices either by transaction or by time period. Whatever method the creditor used, a creditor that guaranteed costs could not charge a consumer an amount that exceeded the quoted total amount.

The guaranteed-cost option is being advocated by various segments of the mortgage industry, including many of the nation's largest creditors. According to these creditors, consumers do not shop for individual settlement services. They say that consumers are more interested in the overall price and that consumers would shop if all they needed to compare was a single guaranteed price for required settlement services. To arrive at a price, these creditors envision entering into volume-based contracts with affiliated and other settlement service providers[20] for such services as appraisals, and "packaging" all the services needed for the loan. They believe that by doing so they will be able to secure discounts that could ultimately be passed on to consumers. Packaging services will keep costs down more effectively than RESPA's anti-kickback provisions, they say, because it will better enable consumers to comparison shop and will encourage creditors and others to package competitively and to pass along discounts.

To package services, however, creditors and others perceive the need for relief from § 8 of RESPA and assert that, if they are willing to guarantee costs, they should be entitled to relief. Section 8 prohibits kickbacks and referral and unearned fees. But the statute gives no clear guidance, they say, on how to determine when a payment has been earned for goods or services or is compensation for a referral. In particular, creditors say it is not always clear when providing a volume-based discount to a creditor or other settlement service provider is considered payment for the referral of business. In addition, the act prohibits requiring the use of an affiliated settlement service provider except in limited circumstances, which can be an impediment to packaging services. Because of the uncertainty about how § 8 will apply, proponents argue that they cannot offer consumers a package of services without a statutory exemption from § 8 for any service included in the guaranteed cost.

[19] Chapter 3 of the report contains a more detailed discussion of which fees would be included in the guarantee and of the exceptions.

[20] As used in this report the term "affiliate" broadly refers to business relationships among related or associated entities and generally does not refer to any specific statutory definition.

Critics of a guaranteed-cost approach include small creditors and independent settlement service providers such as appraisers and title agents. They cite two major concerns. First, they say that the only way a creditor could guarantee costs and remain competitive is by packaging services; and they express serious concern about the ability of smaller, unaffiliated institutions and other settlement service providers to arrange packages and compete in such an environment. Second, they believe that a packaging system would drive prices up and unduly restrict consumer choice. They assert that consumers do in fact shop for individual settlement services, that prices for these services are currently competitive, and that lifting the § 8 restrictions will harm rather than help consumers because, given the market power of the larger companies, it is questionable whether any savings from packaging would be passed on to consumers.

Consumer advocates generally favor the guaranteed-cost approach but express concern nonetheless. Although they believe that guaranteeing closing costs has value, they note that these costs are only a small portion of the overall cost of a mortgage loan. They say that consumers need a firm commitment not just on the closing costs, but also on the interest rate and any points; otherwise consumers cannot truly comparison shop for the best loan. Consumer advocates also worry that unless the interest rate and points are guaranteed, some creditors may be tempted to increase them if, after providing the consumer with a guaranteed-cost quote, they find that the actual costs are in fact higher than anticipated.

An additional issue in the guaranteed-cost approach involves the disclosure of individual services and fees. Consumers generally like to know what services are covered by the fees they are paying. Proponents of guaranteed-costs contend, however, that for the approach to work, creditors should not be required to itemize each of the services and the individual costs. They say that when the disclosure is provided, creditors may not know what precise services they will require or what the costs will be, and they fear liability if they disclose services they ultimately choose not to perform.[21]

A More Reliable GFE

Requiring creditors to provide a GFE that is accurate within a specified tolerance is another approach to making closing cost information more reliable, without requiring costs to be guaranteed. A tolerance would be set by the statute and if the closing costs actually charged exceeded the estimated costs by more than the tolerance, the creditor would generally be held liable. The GFE would continue to include an item-by-item disclosure of all closing costs and these charges would continue to be subject to § 8 scrutiny.

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[21] They also assert that even at closing they may not know the cost for each service. For example, a creditor may contract with an appraiser to do all the creditor's appraisals for six months for a flat fee, and thus the actual cost will depend on the number of appraisals performed.

The tolerance could be based on a percentage of the total estimated closing costs;[22] if the actual costs exceed the sum of the estimated costs and the amount of the tolerance, the creditor generally would be held liable. Alternatively, the tolerance could apply only to certain categories of costs, such as those defined as being outside the creditor's control; charges imposed directly by the creditor would have to be accurate. In either case, an increase in costs resulting from a consumer's choice would not count against the creditor in determining whether the total closing costs exceeded the tolerance.[23] Increased costs associated with specified changes to the transaction, such as an increase in the loan amount, also would not count. But the creditor could not charge an amount that exceeded the tolerance if it determined, for instance, that an additional service was needed, such as a pest inspection.

The potential liability for exceeding the tolerance should be sufficient to encourage accurate estimates. The tolerance should not be so narrow as to effectively require a guarantee of closing costs. Expanded liability could be imposed on creditors that engaged in a pattern or practice of making inaccurate estimates.

Recommendation. The Board and HUD believe that creditors should be required under RESPA to give consumers more reliable closing cost information. This would promote shopping and competition, and reduce the number of instances in which consumers encounter higher costs at closing than were initially disclosed. The finance charge and APR disclosures under TILA also would be improved since many of the costs that go into those disclosures would now be firm.

Specifically, the Board and HUD recommend a disclosure system in which creditors could choose between guaranteeing the closing costs and providing estimated closing costs that are accurate within a prescribed tolerance. This system could provide an incentive to creditors and others to guarantee costs without forcing a complete change in the market; no one would be required to guarantee costs. This approach also offers an opportunity for the market to test whether guaranteed-cost arrangements offer more economical and efficient means for consumers to obtain mortgage loans.

The Board and HUD believe that listing the types of services in a package should be required, and that there are ways to minimize some of the potential problems associated with such a requirement. For example, creditors could provide a list on the initial disclosure of the services that might be performed or, alternatively, provide just the guaranteed cost; the settlement statement could list the services actually performed. However, the Board and HUD

[22] Other alternatives would be to base the tolerance on the loan amount, or to establish a set dollar figure. If a tolerance approach is adopted to provide more reliable estimates, additional study is required to set the tolerance so that it provides creditors with some margin for error but is not so expansive to make the estimates meaningless. For example, the tolerance could be based on a percentage of the total estimate for closing costs, such as 5 percent, but not as high as 25 percent.

[23] For example, if the creditor estimated $300 for the title insurance based on a list of required providers, but the consumer chose a title company that charged $400, the $100 difference would be subtracted from the total before determining whether the total exceeded the estimate plus tolerance. Similarly, negotiations between the buyer and seller regarding who would pay certain fees or points would not affect the GFE.

do not believe that itemizing costs or service providers should be required, although creditors should be allowed to provide this additional information if they so choose.

The Board and HUD recommend granting an exemption from § 8 of RESPA to those offering a package of settlement services at a guaranteed price. The agencies believe that any entity should be allowed to package settlement services. The central purpose of an exemption should be to encourage packaging that would improve the consumer's ability to shop effectively, and thereby allow competitive forces to reduce the cost of a home-secured loan. To carry out this purpose, HUD believes that an exemption from § 8 should be available to creditors and others that meet appropriate conditions, including:

- Offering consumers a comprehensive package of the settlement services needed to close a loan;
- Providing consumers with a simple prescribed disclosure that gives the guaranteed maximum price for the package of services through closing; and
- Disclosing the rate and points offered to the consumer for the loan, with a guarantee that the rate and points will not increase, subject to prescribed conditions.

HUD believes that such a statutory exemption would significantly benefit consumers by giving them guaranteed closing costs and, subject to prescribed conditions, guaranteed rates and points. Receiving guaranteed cost and rate information will help consumers comparison shop, and help protect them from unnecessarily high settlement costs. HUD also believes that a statutory exemption will benefit creditors by eliminating much of the uncertainty that currently surrounds § 8.

Policy Question 3: Should the Timing Rules for Providing Cost Disclosures to Consumers Be Changed (and Should Creditors be Required to Provide Disclosures Before Imposing Substantial Fees)?

In home-secured transactions the consumer currently receives TILA or RESPA disclosures at several different times. Generic information, such as some consumer education booklets, is provided at application. Certain loan-specific disclosures are given at or within three days of application. Final disclosures are given at or about the time of closing.

The congressional mandate requires the Board and HUD to simplify and improve the timing of the disclosures under the two laws. The disclosure process would be simplified for creditors if the timing requirements for providing disclosures were made more consistent. It would be improved for consumers if the disclosures were given when they would be most useful.

For example, HUD's Special Information Booklet, which provides consumers with basic information about home buying and financing, is now provided within three days after loan application for home purchase transactions.[24] That HUD booklet could as easily be provided at application--when the Board booklets describing adjustable rate mortgage loans and open-end home-secured lines of credit, as applicable, are now given. Or the HUD booklet could be given or offered earlier, such as when the consumer first contacts a creditor, realtor, or other settlement service provider. These changes could simplify the disclosure scheme for creditors by having the same time frame for all three booklets and could improve the disclosure scheme by providing educational material to consumers earlier.

A more significant change--from both the consumer's and the creditor's perspectives--would be to modify the timing of the loan-specific cost disclosures. The Board and HUD believe that rapid advances in technology (such as automated underwriting) will allow creditors to provide firm loan costs, including the interest rate and any points, at increasingly earlier stages of the loan origination process.

Initial Loan Disclosures

Consumers need firm information early in the loan application process so that they can compare the products of one creditor or settlement service provider with another. If consumers receive firm information but it comes too late in the loan process, they do not have the opportunity to shop. Moreover, if the information is available but they must pay a significant fee to obtain it, consumers are disinclined to seek comparable information from multiple sources.

In an ideal world, shopping for a mortgage loan would be like shopping for almost anything else. Consumers could find a loan product with features they liked (such as a low down payment) and immediately be told what that loan would cost them. The reality, however, is that determining the price of a loan--particularly the interest rate and, to some extent, the closing costs--is currently more difficult than determining the off-the-shelf price of, say, a television set. To determine the interest rate and points, the creditor generally must evaluate the consumer's creditworthiness. To determine the other costs to close the loan, the creditor must ascertain what services are needed and their price.

Advances in technology continue to make these determinations easier. Greater use of technology makes more accurate information--including credit information--available to creditors more quickly, resulting in consumers' receiving reliable disclosures earlier. As technology advances, loans can be underwritten more promptly because of new capabilities and the prevalence of automated systems. And because automated systems free staff resources for cases that require manual underwriting, many creditors can be expected soon to have the ability to offer early interest rate and point information.

[24] Currently, HUD's Regulation X defines "application" as the submission of information, that identifies a specific property, in anticipation of a credit decision. The Board's Regulation Z adopts the same definition. Accordingly, consumers generally do not receive disclosures in connection with prequalification requests. The Congress may wish to consider whether any disclosures are necessary at the prequalification stage.

RESPA requires creditors to provide the GFE to consumers within three days after application, and many creditors currently provide them even earlier. Under the Board's and HUD's recommendations, creditors or others that choose to package services could provide--virtually at their first contact with the consumer--a guaranteed amount for closing costs since the charges for services in the package would likely result from arrangements with service providers. But other creditors--such as small institutions that do not make many mortgage loans and that might not package services--may need more time to determine the closing costs; they may not always know at first contact which settlement services they will require, which providers they will use, or the prices they will charge.

Providing information on the interest rate and points presents different timing issues for creditors than providing information on other charges. For interest rate, points, and APR information, there is a tension between providing consumers firm, accurate information that will not change and providing them with information sufficiently early in the application process so that consumers can shop. The time needed to make firm information available on rate and points could range from an hour or even minutes, for creditors that have sufficient information and that rely on automated underwriting, to weeks for creditors that underwrite manually, particularly if they must wait for information from outside parties.

Consumer advocates believe that guaranteed cost information, including guaranteed interest rate and points, is more important for effective shopping than receiving disclosures at the earliest possible time. These advocates express concern that since creditors may use the interest rate to defray settlement costs, creditors could underestimate other charges and then recoup them later through the rate or points. Moreover, they say it is critical that consumers not have to pay any significant fee before receiving disclosures of guaranteed closing costs and interest rate and points.

Many creditors say that offering guaranteed rate and points information is not feasible without full underwriting, which is both costly and time-consuming, and that therefore they need to be able to collect a fee before undertaking this work. Some wholesale lenders are further concerned that creditors, including mortgage brokers, will not all be able to adequately underwrite the loans early in the process, and yet would be expected to guarantee rates and points that bind the investors. Other industry representatives counter that many creditors, including many mortgage brokers, currently provide firm information on rates and points early in the shopping process based on credit reports--prior to collecting any fee and without any assurance the consumer will commit to getting a loan from the creditor.

The Board and HUD recommend that consumers be given initial cost disclosures as early in the shopping process as possible. While the agencies differ somewhat in their approaches on this issue, both believe that advances in technology and competitive market forces will result in consumers getting better information at or near application.

HUD's Recommendation. HUD recommends that generic information be provided to consumers at first contact with settlement service providers, including creditors and realtors. HUD believes that consumers should be provided guaranteed information about closing costs, interest rate, and points early enough so that they can shop and make informed choices. HUD also believes that creditors must be able to assure that they have adequate security for their loans. HUD is aware that industry and consumer groups have been working on approaches to assuring that creditors have sufficient information to make a guaranteed offer of interest rate, points, and closing costs early in the shopping process. HUD supports these efforts.

One proposal is that the consumer would arrange for the creditor to have access to the consumer's credit report and to review it before requesting a guaranteed shopping price. The creditor would then provide the consumer with a guaranteed interest rate along with points and closing costs based on the credit report and information the consumer provided on the application, including employment information. (The creditor could also arrange to obtain the credit report directly with the consumer's permission.) At this stage the consumer would be charged only for the cost of the credit report.

Since the creditor would provide the guaranteed information on the strength of the credit report and the consumer information on the application, the guarantee would likely be subject to appropriate conditions, such as verification of the consumer's income and the value of the property. The guarantee would stand for a reasonable time to permit the consumer to shop. And unless the borrower chose to formally apply and "lock" the interest rate, any subsequent change in interest rate and points (but not closing costs) would be permitted, so long as any change to the consumer's guaranteed rate and points was solely attributable to, and commensurate with, changes in the financial markets.

Some in the industry have expressed concerns about guaranteeing the interest rate and points as well as other costs (and other similar approaches), but HUD believes that these concerns can be resolved, particularly in the context of a reform proposal that to a significant extent would end § 8 uncertainty. HUD believes technology promises to make earlier disclosures possible for all loans regardless of whether a creditor chooses to estimate closing costs or to guarantee closing costs, the interest rate, and points.

For those entities opting to guarantee costs, rates and points, HUD recommends that the initial disclosure be provided as early as possible--ideally, at first contact with a creditor, assuming the creditor has received sufficient credit information about the consumer. While HUD seeks early disclosures, it recognizes that in some cases (because of the consumer's credit or employment circumstances) there will be a trade-off between providing an early disclosure and ensuring a disclosure that is firm and complete enough to allow the consumer to shop and to protect against any later increase in costs. For such cases, HUD recommends that the timing requirements be flexible enough to allow time to provide guaranteed information. Moreover, in the interest of promoting shopping, consumers should not be required to pay a significant fee to the creditor prior to receiving such information. HUD therefore recommends that initial disclosures be provided before the consumer pays any significant fees.

For those entities opting to provide firm GFEs, HUD supports requiring that estimated cost disclosures be provided earlier than three days after application--ideally at first contact with a creditor--to offer consumers a more useful shopping tool. Moreover, in the interest of promoting shopping, HUD recommends that initial estimated disclosures be provided before the consumer pays any significant fee.

The Board's Recommendation. Although many creditors can provide consumers with reliable cost disclosures in a relatively short period of time, much of the industry is not yet at the point where it can provide firm closing costs at first contact with the consumer (particularly given the liability that would now attach for exceeding the guarantee or tolerance). Even fewer can fully underwrite a loan within a matter of days. And although consumers need to have firm information, if disclosures come too late they may not be useful. Given this tension between early information and firm information, the Board believes consumers should receive disclosures early in the shopping process rather than after the interest rate and related information can be guaranteed. The Board recommends that the initial cost disclosures (including more reliable closing costs and an APR that may be firm or estimated and interest rate) be provided no later than three days after application.[25]

Whether or not disclosures can be provided early, if the consumer has to pay more than a nominal fee to obtain them, the ability to comparison shop will be seriously curtailed for many, if not most, consumers. The issue is whether restricting a creditor's ability to collect fees is the appropriate response. The Board does not support a statutory limitation on fees. It believes that creditors can keep fees in a reasonable range as they realize savings from the increased use of technology, and that increased competition in the mortgage lending and settlement services markets also will operate to keep application fees down.

Subsequent Loan Disclosures

RESPA seeks to help consumers avoid unexpected costs at closing by giving them the right to request a copy of their settlement statement one day before closing. This right falls short of its goal, however, because few consumers know about it and because there is no requirement that the settlement statement be complete or accurate prior to closing. Moreover, consumers have no parallel right, in advance of closing, to receive a revised TILA disclosure. If the early TILA disclosures change materially they must be updated, but not until closing.

Recommendation. The Board and HUD recommend that, three days prior to closing, creditors be required to redisclose significant changes in the APR or other material disclosures and to provide an accurate copy of the RESPA settlement statement. Consumers would receive final cost disclosures before closing (rather than at closing, the current practice), and would then be able to study the disclosures in an unpressured environment. In

[25] To make timing requirements consistent for creditors and to provide rate and cost disclosures earlier to consumers the Board believes, where applicable, that the HOEPA disclosure (provided for loans with rates and fees above a certain amount) and the reverse mortgage disclosure should be provided at this same time rather than three days before closing (the current rule). (A reverse mortgage is a loan secured by the equity in a home where regular disbursements or a line of credit is made available to the consumer and where the loan balance increases rather than decreases over time.) The Board recommends that the subsequent disclosure rules also apply to the HOEPA disclosure.

any instance where there is a material change from the disclosures provided three days before closing, redisclosure at closing would be mandatory.

In addition, the Board recommends that for nonpurchase home-secured transactions currently subject to the right of rescission, a three-day pre-closing right to a refund should be provided; in most instances, this would substitute for the existing rescission period. Consumers would be given a notice of the pre-closing right to a refund with the cost disclosures given three days before closing. If the consumer chooses not to complete the loan transaction, the creditor should be required to refund all fees as is currently the case under rescission.

Although closing would not be delayed, if the creditor failed to provide timely and accurate disclosures before closing , the creditor would have to give accurate disclosures at closing and the consumer would have a three-day right to rescind, with the flexibility to waive the right. (The more limited waiver rights provided under current law--for personal financial emergencies--would continue to apply to HOEPA loans.) Finally, the three-year extended right of rescission should be available in all instances in which inaccurate material disclosures or no disclosures have been provided--even if a consumer has waived the three-day right of rescission.

Policy Question 4: Should Additional Substantive Consumer Protections be Added to the Statutes?

TILA is primarily a disclosure statute, but has always contained substantive consumer protections such as the right to cancel certain home-secured loans. In 1994, the Congress added to TILA's consumer protections by enacting HOEPA, which contains substantive rules aimed at protecting consumers from abusive lending practices.

Abusive practices continue to exist in some segments of the home-equity lending market, demonstrating the need for additional protections. Although a simpler, earlier cost disclosure scheme will help many consumers comparison shop to avoid the most expensive loans, improved disclosures may not aid comparison shopping significantly in underserved markets where there is less competition. In addition, it is unlikely that improved disclosures alone can adequately protect vulnerable consumers from unscrupulous creditors that engage in deceptive and abusive practices.

The Board and HUD believe that substantive protections dealing with predatory lending practices are necessary to ensure that all consumers benefit from reform of TILA and RESPA. This report discusses three primary areas where legislative efforts might be focused--addressing specific abusive lending practices; enhancing private remedies and public law enforcement; and improving the information available to consumers--and also contains the agencies' recommendations for adopting specific protections. The report also discusses a number of other options that could be considered.

Protection Afforded by the Home Ownership Equity Protection Act

HOEPA was a legislative response to evidence of abusive practices involving loans to elderly and often unsophisticated homeowners who were encouraged to use the substantial equity in their homes as security for credit. These loans, typically for home repairs or debt consolidation, carried high interest rates and fees and repayment terms the homeowners could not possibly meet. Substantial closing costs and other charges were often added to the loan amount, thereby reducing homeowners' equity and increasing their monthly payment. Frequently, the loans included short-term balloon payments that forced homeowners to refinance the debt. In short, because of the homeowners' equity in the property, the loans were sometimes made without consideration of the borrowers' ability to repay.

The practice of offering high-priced loans to "house-rich but cash-poor" consumers has been referred to as "reverse redlining" because creditors target low-income communities and elderly homeowners who have traditionally been denied access to mainstream sources of credit. Because competition in these markets is limited, unscrupulous creditors can make loans with interest rates and fees significantly higher than the prevailing market rates. These loans also may contain onerous terms, such as prohibitively high prepayment penalties that discourage refinancing the loan with other creditors on more reasonable terms.

HOEPA seeks to protect these homeowners from loan agreements that are likely to result in default and the loss of their homes, but it does not limit the rates that creditors may charge or prohibit creditors from making high-priced loans. Instead, the act adds a regulatory scheme for these loans that layers new disclosures onto those required in more conventional transactions and prohibits creditors from including certain terms in loan agreements.

In June 1997, the Board held hearings to assess HOEPA's effectiveness in combating abusive lending practices. At those hearings, consumer advocates reported continued abusive practices in connection with home-equity loans. They expressed concern that, as the total number of subprime loans increases, abusive loans will continue to increase in absolute numbers. Because consumer advocates do not believe that improved disclosures will protect consumers from predatory lenders, they urge that new substantive protections be adopted.

Mortgage industry representatives acknowledge that abusive practices occur, but they assert that such practices are not widespread in the national mortgage market as a whole. They believe that the trend toward securitizing subprime mortgages has served to standardize creditor practices and to limit the opportunity for widespread abuse. In their view, providing consumers with more meaningful cost information earlier in the loan application process, as discussed in this report, will help consumers to compare loans and to avoid transactions with excessive costs. They believe earlier disclosure should also increase market competition, making creditors less likely to offer loans with excessive rates or fees.

Addressing Specific Abuses and Practices by Modifying the Home Ownership Equity Protection Act

Coverage. Some creditors keep their rates and fees just below HOEPA's cost triggers and thus avoid the act's substantive restrictions. Accordingly, consumer advocates suggest that the rate and fee triggers should be lowered to bring more loans within HOEPA's coverage. Consumer groups also assert that because subprime loans carry relatively high rates and fees, consumers need to be protected from predatory lenders that structure loans with repayment terms that are unaffordable given the consumer's income. Thus, they also suggest that an additional criterion be adopted for determining whether a loan is subject to HOEPA's restrictions--the ratio of consumer's total monthly debt payments (including the loan payment) to the consumer's monthly gross income. If a home-equity loan caused the consumer's debt-to-income ratio to exceed a specified amount, HOEPA's protections would apply.

Creditors have some concerns about a regulatory scheme based on debt-to-income ratios. They express some uncertainty about whether they would be able to determine a consumer's debt-to-income ratio with the level of accuracy that would be required to comply with a statutory trigger.

Problems with Loan Flipping. Loan "flipping" or "churning" refers to the frequent refinancing of home-secured loans, which typically provides little economic benefit to the consumer in comparison to its cost, but which provides significant income to the creditor, principally in points and fees charged on the new loan. Flipping can occur when consumers are unable to make the scheduled payments on their existing loans and are forced to agree to a new loan to avoid default or foreclosure. It also may occur when a creditor solicits a borrower to refinance a loan by offering additional cash, lower monthly payments, or both. Because the costs of the refinancing are usually added to the loan amount, loan flipping typically reduces the homeowner's equity in the property.

HOEPA seeks to prevent flipping by prohibiting certain loan terms that may create unaffordable repayment obligations. For loans with terms of less than five years, HOEPA prohibits creditors from offering non-amortizing loans with affordable, low monthly payments that also include a balloon payment that the consumer cannot afford to repay unless the loan is refinanced. Similarly, the act prohibits using payment schedules that cause the principal loan balance to increase (negative amortization), so that a substantial payment is still due after all scheduled monthly payments are made.

To curb loan flipping, consumer groups believe that balloon payments should be prohibited altogether for high-priced HOEPA loans. They say that consumers are just as unlikely to repay or refinance these loans on more affordable terms after five years than they are after two or three years. Many creditors, however, believe that low monthly payments with a balloon payment can be useful for consumers experiencing cash-flow difficulties and for consumers who intend to sell their homes before the balloon payment is due and, therefore, they contend no further restrictions are warranted.

Loan flipping strips consumers' equity by charging excessive up-front fees that are added to the loan amount. Thus consumer advocates also suggest limiting or prohibiting the amount of closing costs or other fees that a creditor is permitted to finance. Fees that could not be financed and added to the loan amount would have to be collected in cash at the closing or built into higher interest rates. However, this approach might deter some legitimate refinancings. Some consumers may prefer to draw on their equity to meet closing costs and retain their cash reserves for obligations that are more difficult to finance.

Rules for Sales of Credit Insurance. Consumer groups continue to express concern about the sale of credit insurance (life, disability, and unemployment). They state that consumers are frequently subjected to high-pressure sales tactics at the loan closing, with little opportunity to comparison shop or reflect on the decision. They also state that consumers are sometimes charged exorbitant premiums that are not included in calculating whether a loan is covered by HOEPA.

Consumer groups also express concern about the practice of collecting the insurance premiums for the entire loan term in advance. Moreover, these premiums are usually added to the loan amount, which increases the total finance charges paid by the consumer. If the loan is later refinanced or is paid off before maturity, the entire premium will not have been earned, but consumers may not know to seek a rebate, or may not know how to do so.

It may be feasible to prevent some abusive practices by regulating the method for collecting credit insurance premiums in connection with HOEPA loans. Creditors could be required to collect the premiums with the consumer's regular mortgage payment so that termination of the loan automatically cancels both the coverage and any liability for future payments. If this is done, consumers' need to finance the premiums and add the cost of insurance to the loan amount would be eliminated.

Ensuring Adequate Private Remedies and Public Law Enforcement

Creditors that engage in abusive practices are unlikely to be deterred by additional rules and prohibitions alone. The effectiveness of the law in dealing with abusive practices also depends on adequate enforcement by government agencies and by consumers.

Additional Consumer Remedies for Unfair or Deceptive Practices. Consumer advocates seek a federal unfair and deceptive acts and practices (UDAP) remedy for individuals that extends beyond HOEPA coverage.[26] Currently, enforcement actions brought under the Federal Trade Commissions's (FTC) authority generally target only a pattern or practice of wrongdoing. The FTC Act does not include a private right of action. A federal statute providing private UDAP remedies could achieve some uniform coverage by declaring

[26] UDAP statutes that have already been enacted into state law provide such a remedy, but do not apply to home-secured loans in all states.

certain practices unlawful per se or define those circumstances that create a rebuttable presumption that a particular act is unfair or deceptive.

Ensuring Consumer Rights in Foreclosures. Consumers who have been victims of abusive practices must have adequate opportunity to assert their rights in order to avoid unwarranted foreclosures. For the most part, the procedures that a creditor must follow for foreclosure are governed by state law, local practice, and the terms of the relevant contract documents. This includes the amount or type of notice that consumers are entitled to receive about an impending foreclosure.

Some states require creditors to provide actual notice to the consumer of the foreclosure, but in other states notice by publication is deemed sufficient. In some states, consumers have the right to "cure" a delinquency or default and avoid foreclosure by bringing the obligation current. Even after the time to cure the delinquency has passed, consumers usually have the right to "redeem" the property prior to the foreclosure sale by paying off the full amount of the mortgage plus any fees and expenses related to foreclosure.

Consumer advocates believe that existing state laws do not adequately protect consumers in connection with foreclosures. Specifically, they believe that consumers should have a right to cure their delinquency and redeem the property in all cases. Consumer groups are also concerned that consumers may not receive adequate notice of the legal options that are available to them. Some home-equity creditors have also voiced support for legislation to provide additional protection for consumers in foreclosure, including the right to an appraisal and a private sale of the property in some cases.

To avoid unwarranted foreclosures, minimum standards could be enacted for the type of notice creditors must give consumers prior to foreclosure, including: an explanation of any right the consumer may have to cure the deficiency or redeem the property; what the consumer must do to exercise these rights; the process that will be followed in any foreclosure; and information about the availability of third-party credit counseling. Additional protections could also be enacted for home improvement loans, to enable consumers to more easily assert their claims concerning a contractor's nonperformance before foreclosure could commence.

Consumer Education and Counseling

Mortgage loans are inherently complicated transactions, and the process has become even more complex as the variety of available loan products has multiplied. Informed consumers are likely to make better decisions, and consumers who obtain information from a variety of sources--either by comparison shopping or consulting public information resources--are probably less likely to become victims of abuse.

Consideration should be given to how to increase the public's awareness of these facts, and how to facilitate consumers' ability to gather relevant information. Increased efforts by industry groups to educate consumers could have a significant impact. New educational materials or other tools, including videotapes and computer programs, could be developed for wide distribution. This might be undertaken by the mortgage industry in conjunction with consumer and community organizations. Distributing written materials at the point of service may also be effective in reaching some consumers, particularly those who in the past have been targeted for abusive loans. As personal computers become even more affordable and more common in homes, schools, and public libraries, more consumers will obtain information in this manner. Thus, the innovative use of technology to reach consumers should be explored.

In appropriate circumstances, counseling about the credit options that are available would assist consumers in making better informed decisions. Currently, pre-loan counseling is required under federal law before some extensions of credit are made, such as reverse mortgages guaranteed by HUD under its Home Equity Conversion Mortgage program, because these transactions are complicated and contain some risk. In other situations, such as default on an FHA-insured loan, consumers are merely provided with information on the availability of HUD-approved counselors (although they are not required to consult one). Either approach could be expanded and coupled with consumer education. To be effective, however, there must be adequate resources dedicated to this purpose, to expand and improve on the existing base of housing counselors.

Recommendation. The Board and HUD recommend that substantive protections be adopted that will target abusive lending practices without unduly interfering with the flow of credit, creating unnecessary creditor burden, or narrowing consumers' options in legitimate transactions. These protections should be included as part of any legislation enacted to simplify and reform TILA and RESPA, to ensure that all homeowners benefit from the statutory reform. Any new rules should be part of a multifaceted approach that also includes nonregulatory strategies, such as increases in counseling and education efforts and voluntary industry action.

The Board and HUD specifically recommend:

- Extending HOEPA's restrictions on balloon payments beyond the current limitations or prohibiting them altogether for HOEPA loans (or possibly the highest-priced HOEPA loans);

- Prohibiting the advance collection of lump-sum credit insurance premiums for HOEPA loans, so that consumers may pay premiums periodically with their regular mortgage payments and so that termination of the loan automatically cancels both the coverage and any liability for future payments; and

- Requiring certain minimum standards for the notice creditors must provide in home foreclosures, including a written notice explaining consumers' legal rights and how they may avoid foreclosure, the process that will be followed if they do not exercise those rights, and information about the availability of third-party credit counseling.

In addition, HUD recommends:

- Lowering HOEPA thresholds combined with prohibitions against loan flipping and other specific abusive practices including such measures as regulating the financing of closing costs, requiring creditors to take into account the consumer's capacity to repay, expanding the current restrictions on prepayment penalties, and providing new protections for home improvement borrowers claiming contractor nonperformance or malfeasance;

- Adopting new foreclosure prevention strategies that, where appropriate, include pre-foreclosure counseling and establish new federal rights for consumers to cure delinquent loans and recover remaining equity through a private sale prior to foreclosure;

- Requiring education and pre-transaction counseling, where appropriate, for certain borrowers;

- Imposing information collection and reporting requirements on certain creditors that make loans covered by HOEPA; and

- That the Congress consider establishing a federal "unfair and deceptive acts and practices" standard to provide a private remedy in transactions that are unfair or unconscionable.

OTHER ISSUES DISCUSSED IN THE REPORT

Besides the four policy questions discussed above, the report addresses many other issues, including consumer education, important issues associated with TILA and RESPA reform, such as the varying coverage of the two statutes, and some issues related to each statute specifically.

In addition to the agencies' recommendations, the Board and HUD believe that there should be a commitment to educating consumers about the information presented in the new disclosures. In particular, consumers must understand the uses of the APR and the two disclosure approaches--guaranteed and estimated settlement costs--for purposes of shopping and negotiating loan terms.

The report discusses the present failure of the RESPA provisions to include adequate remedies for violations of its rules and makes recommendations for streamlining and improving the existing provisions. The report contains HUD recommendations for expanded enforcement authority under RESPA for HUD and state attorneys general, added remedies through private causes of action, standardized statutes of limitation, as well as new disclosures relating to escrow accounts and private mortgage insurance. The report also discusses other TILA disclosures such as the amount financed, and possible technical changes to HOEPA.

HUD'S FRAMEWORK OF "ESSENTIAL REFORM" AND ADDITIONAL RECOMMENDATIONS

Whether or not the Congress chooses to enact an exemption from § 8, HUD believes that improvements to the existing RESPA disclosure scheme are critical. HUD supports, at minimum, an "essential reform" package to simplify and improve RESPA-TILA disclosures that would do the following:

- Require dissemination of educational booklets to consumers for various types of loan transactions--including refinancings and subordinate liens--early in the homebuying and mortgage process (for example, by requiring real estate agents or loan originators to provide settlement cost booklets to consumers at first contact).

- Combine and simplify the RESPA and TILA disclosure forms to be provided to consumers. The disclosure should also inform consumers of the functions of mortgage originators, and of the requirements for escrow accounts and private mortgage insurance. Also, definitions for disclosures under RESPA and TILA should be coordinated to the greatest extent possible.

- Coordinate the timing of RESPA and TILA disclosures to the greatest extent feasible. HUD supports disclosure earlier than three days after application under an improved RESPA disclosure scheme to offer consumers a more useful shopping tool. HUD believes technology promises to make earlier disclosure possible for all loans. HUD agrees with the Board that the consumer should receive the settlement statement and any necessary redisclosure of rate-related information three days prior to closing.

- Require more accurate estimates of settlement costs. Early disclosures of estimated settlement costs within the control of the creditor should vary little from final costs. Tolerances or other mechanisms may beappropriate for costs outside the creditor's control.

- Establish new and simplified remedies to protect consumers against inaccurate disclosures and the failure to provide disclosures. RESPA's remedies should be expanded and simplified and its statute of limitations extended and standardized to ensure better consumer protection against RESPA violations. RESPA should have strengthened criminal sanctions and should include expanded injunctive authority and civil remedies. It should also provide for expanded remedies available through private causes of action.

Board of Governors of the Federal Reserve System
Department of Housing and Urban Development

Joint Report to the Congress Concerning Reform to the Truth and Lending Act and the Real Estate Settlement Procedures Act

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Chapter 1. Introduction

The Truth in Lending Act (TILA)[1] and the Real Estate Settlement Procedures Act (RESPA)[2] regulate mortgage transactions. The two statutes differ in fundamental ways but have a common goal: to ensure that consumers receive important cost information about their mortgage loan transactions.

For consumers, the current TILA and RESPA disclosure rules may fall short of meeting their intended goals. Frequently, consumers must pay a fee before receiving the required disclosures, and then may receive them too late to find them helpful in comparison shopping. Consumers may also discover that the cost estimates they receive under RESPA differ significantly from the final figures and they have no federal remedy to address inaccuracies. They may find that certain cost information in the TILA disclosures--such as the APR and the amount financed--is not readily understandable. In addition, abusive lending practices targeting consumers persist, and the current laws offer limited protections and remedies.

For creditors and other settlement service providers, the TILA and RESPA rules can be complicated and may pose liability risks.[3] Under TILA, creditors may be subject to substantial liability in class action lawsuits for misclassifying some fees used to calculate the finance charge and the APR. Amendments to TILA have substantially reduced creditors' potential liability, but compliance nonetheless remains burdensome. Under RESPA, creditors may be subject to both civil and criminal penalties for violating the § 8 prohibitions against kickbacks, referral fees, and unearned fees, but the act does not provide specific guidance on what fees are or are not unlawful. Some in the industry view these prohibitions as an impediment to operational efficiencies that could streamline the mortgage process to consumers' benefit. At the same time, others in the industry worry that eliminating or making exceptions to the prohibitions could adversely affect consumers and lead to the consolidation of the mortgage loan origination market into the hands of a few large companies.

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[1] 15 U.S.C. § 1601 (1994 & Supp. II 1996).

[2] 12 U.S.C. § 2601 (1994 & Supp. II 1996).

[3] As used in this report, "creditor" refers to an entity that originates mortgage loans and is covered by either TILA or RESPA. Under TILA, the term "creditor" means a person who regularly extends credit and to whom the obligation is made payable. RESPA uses the term "lender," which generally has the same meaning as "creditor" under TILA, but excludes certain mortgage brokers and dealers. (See 24 C.F.R § 3500.2 (1997) for the complete definition of lender).

For purposes of this report, the term "settlement service providers" generally refers to entities that provide services used in connection with real estate settlement, such as appraisers, title companies, and real estate brokers. Under RESPA, the term also includes mortgage loan originators.

Section 2101 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996[4] directed the Board of Governors of the Federal Reserve System (the Board) and the Department of Housing and Urban Development (HUD) to simplify and improve the disclosures given in transactions subject to TILA and RESPA, including the timing for providing those disclosures. The agencies were also asked to create a single TILA-RESPA disclosure statement, if feasible, that would meet the purposes of the acts. These changes were to be made by regulation, if possible; if statutory amendments were necessary, the Board and HUD were to make legislative recommendations. In 1997, the agencies concluded that meaningful change could come only through legislation. This report presents the Board's and HUD's recommendations for revising TILA and RESPA.

The report discusses various ways of streamlining and simplifying the current statutory requirements for mortgage loans, to provide consumers with more meaningful cost information about home-secured transactions and to make compliance easier for creditors.[5] It analyzes major policy questions and its focus and language are broad. The report does not explore all of the details that must be addressed in making changes to TILA and RESPA, statutes with highly technical requirements in some instances. The recommendations and illustrative disclosure forms are a starting point for congressional consideration; they do not change any existing regulatory requirements.

A. *Overview of TILA and RESPA Rules*

TILA and RESPA are intended to assist consumers in understanding the costs of various aspects of home-secured lending. Both acts have disclosure requirements--TILA's focus on consumers' borrowing costs and RESPA's on real estate settlement costs--and both contain some substantive protections.

1. Disclosure. Enacted in 1968, TILA is intended to promote the informed use of consumer credit by requiring disclosures about its terms and cost. The act covers credit offered to individuals for personal, family, or household purposes for closed-end (installment) transactions or under open-end (revolving) credit plans. TILA directs creditors to highlight four key cost figures in the required disclosures for home-secured closed-end credit. In the past ten years, rules have been added to require detailed disclosures for variable-rate loans secured by real estate, home-equity lines of credit, reverse mortgages, and

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[4] Pub. L. No. 104-208, 110 Stat. 3009.

[5] This report focuses on closed-end mortgage loans, whether first or subordinate liens. The impact of reform could be much broader. For example, TILA and RESPA also address home-secured open-end credit plans. Further, any revisions to TILA, whether adjusting the components of the finance charge or eliminating other disclosures, could affect all consumer credit transactions.

the home-equity loans covered by the Home Ownership and Equity Protection Act of 1994 (HOEPA).[6] TILA is implemented by the Board's Regulation Z.[7]

The purpose of RESPA, enacted in 1974, is to provide consumers with timely disclosures regarding the nature and costs of the real estate settlement process. RESPA mandates disclosures for transactions involving "federally related mortgage loans," a term that encompasses most transactions creating a lien on owner-occupied residences. The act requires that consumers be informed about the costs of settlement services through estimates provided soon after the consumer applies for credit and through a settlement statement provided at the loan closing.[8] RESPA also imposes other disclosure requirements in the mortgage servicing process, including initial and annual escrow account statements and notices of the transfer of servicing. RESPA is implemented by HUD's Regulation X.[9]

Both TILA and RESPA are intended to assist consumers when they are shopping for mortgage loans. Creditors must calculate and disclose costs covered by the respective acts in a uniform manner so that consumers can make comparisons between different creditors' cost disclosures and estimates. The regulations provide model forms and suggested formats to promote this goal.

Both statutes have a series of timing requirements for providing cost disclosures for mortgage loans. A chart illustrating these rules is found in chapter 4. Under TILA, consumers seeking closed-end mortgage credit generally must receive the cost disclosures before they become obligated on the transaction, which typically means at loan closing; for home-purchase loans, creditors must provide the cost disclosures within three days after application.[10] For certain variable-rate, home-secured loans and home-equity lines of credit, consumers receive generic disclosures when they obtain an application. Additional cost disclosures for reverse mortgages or the high-priced home-equity loans covered by

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[6] 15 U.S.C. § 1601 (Supp. II 1996). Generally, nonpurchase money, closed-end home-secured loans with rates and fees above a specified amount are subject to HOEPA.

[7] 12 C.F.R. pt. 226 (1998).

[8] As used in this report "closing" refers to either consummation or settlement, as applicable under TILA or RESPA respectively. TILA defines consummation as the time that a consumer becomes contractually obligated on a credit transaction, as determined by state law. RESPA refers to settlement and defines it as the time that the consumer executes legally binding documents regarding a lien on property subject to a federally related mortgage loan.

[9] 24 C.F.R. pt. 3500 (1997).

[10] The report uses the term "day" generally means business day as defined by RESPA and TILA. There are, however, special rules for counting business days regarding rescission and HOEPA loans.

HOEPA must be provided at least three days before consumers become obligated on the transaction.

Creditors provide a number of RESPA disclosures at or within three days after their credit application, including a good faith estimate (GFE) identifying the charges that consumers are likely to incur in connection with the transaction.[11] Consumers must be informed about the relationship (and any associated costs) between a creditor and any settlement service provider that the creditor requires the consumer to use. Before or at closing, consumers must receive a settlement statement (the HUD-1) that itemizes all costs imposed on the borrower and the seller in connection with the settlement.[12] Consumers may request their HUD-1 settlement statement one day prior to closing, but the settlement agent is required to disclose only those costs known at the time the agent responds to the request. Typically, settlement agents do not prepare final HUD-1 statements until hours before closing; thus, consumers often learn the full costs associated with the transaction for the first time at the closing table.

2.· *Substantive Protections.* RESPA prohibits certain practices that could increase settlement costs. Settlement service providers may not refer business to any person for a fee or thing of value, or receive unearned fees in connection with settlement services except for services actually performed. Other substantive protections in RESPA include limits on the amounts creditors can collect for escrow accounts, prohibitions on sellers' requiring the purchaser/borrower to obtain title insurance from a particular title company, and rights for consumers when loan servicing is transferred.

TILA provides a variety of substantive protections for consumers entering into home-secured loans. For example, TILA provides that, in some cases, consumers may cancel loans secured by their primary home within three days of becoming obligated on the loan. These rescission rules do not apply to consumers obtaining home-purchase loans.

In 1994, the Congress responded to evidence of abusive lending practices by amending TILA to include HOEPA, which applies to nonpurchase, home-secured loans with high rates or high closing fees. Under HOEPA, creditors are prohibited from including certain terms in loan agreements for HOEPA-covered transactions, such as balloon payments

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[11] Disclosures provided in addition to the GFE are: HUD's Special Information Booklet that explains the mortgage process (required only for purchase transactions), and disclosures regarding the possibility of mortgage servicing transfers and consumers' rights upon such transfers.

[12] The settlement statement is available in two different formats. The "HUD-1," which contains information on both the credit and purchase aspects of the transaction, is required for all mortgage loans involving a borrower and a seller. The "HUD-1A," an abbreviated form that omits purchase-related information, may be used for transactions in which there is no seller, such as refinancings. Since the HUD-1 may be used for all transactions, the discussion will focus on the HUD-1, but it applies equally, in most circumstances, to the HUD-1A.

for short-term loans, and they are prohibited from relying solely on consumers' homes as the source of repayment.

B. Scope of Report and Major Policy Questions

Interest in mortgage reform extends beyond the congressional mandate to simplify and combine the TILA and RESPA disclosures. Many consumer groups and large segments of the mortgage lending and settlement services industries believe more fundamental reform of the statutes is needed. In extensive meetings with these parties, the two agencies gained important insight into the current state of the mortgage loan origination industry, and explored the different perspectives on how TILA and RESPA revisions could improve the mortgage loan process. Using the information gathered from meetings, surveys, focus groups, and public comment letters, the Board and HUD identified four policy questions as the key issues in TILA-RESPA reform.[13] The four policy questions are:

- *Should the finance charge and APR disclosures in TILA be eliminated, or should they be modified and retained?*
- *Should creditors be required to provide firmer quotes for closing costs disclosed under RESPA?*
- *Should the timing rules for providing cost disclosures to consumers be changed (and should creditors be required to provide disclosures before imposing substantial fees)?*
- *Should additional substantive consumer protections be added to the statutes?*

In addition, as a result of its analysis on these issues, HUD has identified an "essential reform" package--the minimum reforms that HUD believes the Congress should consider enacting.

The Board and HUD believe that, considered as a whole, the recommendations for changes to TILA and RESPA presented in this report strike an appropriate balance among the competing concerns of consumers, creditors, and other settlement service providers. These recommendations can form a starting point for congressional consideration of legislative changes to TILA and RESPA. The suggested statutory changes, if adopted, could

[13] Appendix B summarizes steps taken by the Board and HUD to meet the Congress's mandate to reform and simplify TILA and RESPA disclosures.

provide consumers with better and firmer information about the costs associated with home-secured credit transactions and could provide creditors with clearer rules.[14]

Chapter 2 of the report discusses how the current TILA cost disclosure rules for mortgage credit could be improved, including possible modifications to TILA's "finance charge" and "APR" disclosures. Chapter 3 considers ways to improve RESPA's disclosure of settlement costs to provide consumers with firmer costs. The chapter also discusses HUD's "essential reform" package. Chapter 4 discusses the timing of TILA and RESPA disclosures. Chapter 5 addresses the right to rescind certain transactions under TILA--the "right of rescission." Chapter 6 discusses abusive lending practices and possible approaches for combating them. Chapter 7 addresses additional areas for possible simplification of TILA and RESPA and reforms to remedies under RESPA. Disclosure forms based on the discussions and recommendations in the report--and provided for illustrative purposes only--are in appendix A.

[14] In its deliberations about the scope of reform, the Congress must weigh whether the goal of reform--harmonizing TILA and RESPA to create simpler and more useful mortgage loan disclosures--is better met if any modification to TILA is confined to closed-end mortgage loans or is applied to all consumer credit transactions.

Chapter 2. Improving the TILA Cost Disclosures

Should the Finance Charge and APR Disclosures in TILA Be Eliminated, or Should They Be Modified and Retained?

TILA seeks to promote the informed use of credit through standardized disclosures that reflect the cost of credit over the life of a loan and highlight certain credit terms.[15] It focuses consumers' attention on four disclosures to evaluate the cost of installment loans (closed-end credit): the *finance charge*, the *APR*, the *amount financed*, and the *total of payments*.[16] In regard to improving and simplifying TILA, most of the attention has focused on two issues: (1) whether the APR should be retained as a benchmark of the overall cost of credit, and (2) whether the definition of a finance charge should be revised to include more (or fewer) costs.

The "finance charge" is the cost of consumer credit expressed as a dollar amount. It includes interest and other costs such as origination fees, discount points, and private mortgage insurance (PMI).[17] The APR for closed-end credit is the finance charge expressed as an annualized rate that can be used to equate mathematically the stream of payments made over the life of the loan to its present value (the amount financed). Under the existing law, some costs--mainly closing costs such as real estate title insurance fees--are not treated as part of the finance charge and are excluded from the APR calculation for mortgage loans.

The "amount financed" reflects the amount of proceeds available to the consumer. It is used to calculate the APR. (For example, if a consumer signs a note for $100,000 but pays for three discount points from the proceeds--a point being 1 percent of the loan amount--the "amount financed" is $97,000, the net amount.) The "total of payments" states the total dollar amount of the transaction over the loan term, including principal and finance charges.

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15 See appendix A for a sample of the current TILA disclosure form (A-1).

16 For credit sales transactions, the "total sale price" is also highlighted. TILA further requires creditors to disclose the payment schedule; an itemization of the amount financed, upon request; if the rate may increase, the circumstances under which the rate may increase, limitations on the increase, the effect of an increase, and an example; any demand feature, prepayment penalty, late payment charge, security interest taken, assumption policy and required deposit; filing fees to record security interests; and premium costs related to property insurance purchased through the creditor, and credit life or disability insurance or debt cancellation coverage purchased at the consumer's option. The cost disclosures for home-secured open-end plans differ somewhat, as credit costs generally depend on the extent to which the plan is accessed.

17 Private mortgage insurance protects the creditor against loss if a consumer defaults and has insufficient equity in the home that secures the loan.

A. The Finance Charge and the Annual Percentage Rate

1. ***Background.*** Before the enactment of TILA, creditors could advertise a loan rate, such as 6 percent, but could calculate the interest charged to the consumer by using a simple interest, an add-on, or a discount rate. The advertised rates might be the same, but the amount of interest paid over the loan term would differ under these approaches.

A uniformly calculated rate became one of the two key figures under TILA designed to facilitate consumers' informed use of credit. In enacting TILA, the Congress designed the key dollar and rate disclosures to do more than compare the cost of credit using the amount of *interest* that consumers would pay over the life of the loan. Instead, TILA defines the finance charge broadly to include *any charge* payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. Costs paid in a comparable cash transaction--sales or property taxes, for example--are not a finance charge. The idea was to capture the *cost of credit* in whatever form imposed by the creditor or paid by the borrower.

Whatever the initial intention, however, neither the finance charge nor its corresponding APR currently discloses a total cost of credit. From the start, the Congress narrowed the concept by carving out several fees from the definition of the finance charge. Among the statutory exclusions are (1) some closing costs associated with loans secured by real estate (title insurance, appraisals, and document preparation), (2) certain insurance premiums if the cost and other disclosures are provided (property insurance), and (3) fees paid to government officials to record security interests (mortgage recording fees) if itemized and disclosed.

Over time, the Board too has followed this "some fees in, some fees out" structure for the finance charge in its implementation of TILA. For example, the Board generally has excluded application fees for both open- and closed-end credit.

For most closed-end transactions, consumers receive a finance charge and APR disclosure once before becoming obligated on the loan. The components of the total dollar finance charge--for example, interest, points, and fees--are not required to be itemized. The APR is calculated based on the amount of credit provided to the consumer in relation to the amount and timing of payments to the creditor.

Under TILA, loan costs excluded from the finance charge and the APR are disclosed to the consumer in limited circumstances. For example, mortgage recording fees must be disclosed to be excluded from the finance charge. Other fees such as appraisal and title insurance fees for home-secured loans are excluded from the finance charge; and if paid in cash, these fees generally need not be disclosed. They are included in the amount financed if the consumer finances them and would be itemized at the consumer's request. Under RESPA, the fees would be disclosed to the consumer on the GFE and settlement statement.

2. ***Concerns with the Finance Charge and Annual Percentage Rate***. The calculation and disclosure of the finance charge and the APR have been at the heart of the debate over both the usefulness and the regulatory burden of TILA. Much of the difficulty arises not from the mathematical requirements for calculating the finance charge and the APR, but from the issue of what is a finance charge and what is not. With a clear answer to this question, disclosure of the finance charge becomes straightforward, and the mathematical calculation and disclosure of a percentage rate of costs become relatively simple. But even with clear rules about what is or is not a finance charge, there may be questions about whether the figure is as helpful to consumers as it could be. Some critics have suggested eliminating the finance charge and the APR disclosures altogether.

a. Preserving the APR as a Benchmark. With the enactment of TILA in 1968, the APR was viewed as the key benchmark figure that consumers could rely on to evaluate credit costs. Its preservation as a benchmark for consumer shopping has considerable support. A single figure is simple to use. For example, consumers can evaluate competing products using one variable rather than having to consider multiple figures such as discount points and interest rates. Also, the APR has a nearly thirty-year history in consumer finance disclosures. The value of its familiarity was supported by consumers participating in the Board's focus group meetings of February 1998.[18] In addition, the APR concept deters hidden or "junk" fees to the extent that the fees must be included in the APR calculation.

The APR as a benchmark does of course have certain limitations. For loans secured by real estate and for home purchases in particular, the APR provides a relative ranking of costs. However, the APR does not, and is not intended to, consider all of the factors that consumers weigh in determining the best loan. For example, the APR cannot tell a consumer whether the best economic choice is to bear credit costs by paying interest paid over time in the rate or paying points up-front; the answer may depend on how long the borrower intends to hold the loan. Consumers who prepay several points for a thirty-year mortgage and who sell their homes after a brief period may have a higher cash outlay over that period than for another loan with a higher APR composed of fewer points and a higher interest rate. Similarly, the APR does not, and is not intended to, tell consumers about the financial impact of the amount of the monthly payment or the down payment. And even if the APR could somehow enable consumers to evaluate every cost, information unrelated to costs--such as prepayment penalties or a creditors' ability to meet a selected closing date--can be as important as costs for some consumers.

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[18] See appendix B for a general discussion about the Board's focus group results.

Creditors and consumers say that as currently composed, the APR is not particularly helpful. Creditors express dissatisfaction in explaining the APR to consumers--in part because it is difficult to explain that the APR reflects the "cost of credit" since it represents only *some* of the costs of the credit transaction.

Participants in the Board's focus group meetings of February 1998 generally were unsure what the APR represents or how to use it, but some nonetheless favored the concept of a single rate that incorporates the total cost of credit. Others stated that only the interest rate is useful. Some consumers assumed the APR is the same as the interest rate, which may be logical to the extent that consumers expect an interest rate to be disclosed and that the only rate information currently provided under TILA is the APR.[19]

Although it does not embody all cost considerations, the APR, if modified to more accurately reflect the overall cost of credit, can play an important role in consumer shopping. The APR can help a consumer evaluate the relative cost of mortgages if payments are made as scheduled over the loan term. In addition, disclosing the note interest rate in conjunction with the APR, along with a further explanation, would improve consumer understanding. Both consumers responding to a Board study and the focus group participants wanted to see the interest rate for their mortgage loan as a part of their cost disclosures.[20]

b. Improving the Finance Charge. The concept of a finance charge has been problematic from its inception. The fundamental problem may be that creditors and consumers have different perspectives on the "cost" of credit. One view looks at "what the creditor receives" or requires to provide the credit. Another view is that TILA disclosures should identify "what the consumer pays" in connection with the credit transaction, even though some portion may not be paid to the creditor. From this perspective, TILA would include as finance charges all charges paid by the borrower both to the creditor and to third parties, including mandatory fees paid to government agencies and fees paid to service providers for optional services such as owner's title insurance. Depending on the perspective taken, some costs are finance charges, others are not, and certain costs may be finance charges some of the time. Nonetheless, under TILA all costs associated with the transaction must be disclosed properly in the right categories all of the time, finance charges or not, to avoid liability for mistakes.

19 Consumers' failure to understand percentage rates may not be due to the complexities of TILA itself; the mathematics of percentage rates generally are misunderstood.

20 A study, conducted by the University of Michigan's Survey Research Center through the Survey of Consumers, provides insight into information that consumers use to shop for credit and on consumers' understanding of the APR. See appendix B for a summary of the study.

For example, interest and discount points are always viewed as a finance charge. Voluntary insurance premiums to protect the debtor's life or collateral may or may not be perceived to be a finance charge, depending on whether the cost is viewed from the consumer's or creditor's perspective. What if the creditor requires insurance? Is the premium a finance charge or not? (TILA says no for some kinds of insurance and yes for others.) What if a consumer obtains optional insurance or some other aspect of the credit package from a third party, and the creditor does not know the cost? What is the proper disclosure? Although in theory it is possible to specify what costs of credit are finance charges and what costs are not, implementation has not always been simple and the meaning of disclosures to consumers is not always clear. TILA must answer these questions rationally and consistently if creditors are to receive proper guidance and consumers to receive useful information for credit shopping.

TILA's requirement to disclose some but not all costs as finance charges has been particularly problematic for loans secured by real estate. In such a transaction, certain fees are associated solely with the cost of credit, such as interest, discount points, or PMI. Other fees typically required by creditors are for services such as appraisals, title insurance, preparation of loan-related documents, and the like. These required fees are excluded by the statute from the finance charge; but they seem to fit within the concept of a finance charge and, from the consumer's perspective, represent charges for obtaining the loan just like points and other fees.

Complications exist beyond the fundamental question of whether the finance charge is determined from the creditor's or consumer's point of view. Often services associated with real-estate secured loans are performed by third parties, such as appraisers or title companies. Generally, fees charged by third parties for services required by the creditor are included in the finance charge, although statutory exceptions exist. Creditors covered by TILA have argued that the finance charge should never include (and that they should not face potential liability for incorrectly disclosing) costs that may be imposed by settlement agents or third-party service providers. Although the services are required, the creditor may have little direct control over the agent or provider, and may not even be aware of some fees that are imposed.

The Board annually receives telephone calls on TILA in the thousands. Many of them involve questions about the proper characterization of a fee imposed in connection with transactions secured by real estate. For example, if a fee to appraise the property is excluded from the finance charge, how should creditors treat a fee to review the appraisal? (The review fee is excluded from the finance charge.) If a fee to inspect the property before the creditor extends credit may be excluded from the finance charge, how should fees for periodic inspections during the loan term be treated? (The periodic inspection fee is a finance charge.) In response to creditors' uncertainty, guidance has been given on issues such as these based on the facts and circumstances of each transaction.

The "some fees in, some fees out" approach is complicated.[21] It has resulted in litigation about the proper characterization of costs associated with credit transactions, particularly for loans secured by real estate, where an error in judgment may leave a creditor vulnerable to civil money penalties under the act, as well as to rescission claims for up to three years after the loan closed.[22]

The Congress addressed effectively many creditors' concerns about liability for minor finance charge classification errors in the Truth in Lending Act Amendments of 1995.[23] The 1995 Amendments excluded from the finance charge some costs that had been the subject of litigation. But at the same time, the Amendments defined mortgage broker fees to be finance charges in all cases, a change from the previous rule that considered mortgage broker fees to be finance charges only if creditors required consumers to use a given broker to obtain the loan. Thus, the Congress reacted to and sought to address the complexities of the "some fees in, some fees out" scheme, yet perpetuated the unwieldy structure by excluding even more fees from the finance charge and by adding others.

In all its deliberations about possible modifications to the finance charge and the APR, the Board is guided by the major principles used by the Congress in enacting TILA: (1) credit costs must be fully disclosed so that consumers know all the terms and are better able to decide which offer to accept; (2) the cost of credit should be stated in terms that consumers understand so that comparing costs among creditors is easy; and (3) the cost of credit from all creditors should be stated comprehensively and uniformly to promote comparison shopping and competition.

There is broad agreement that TILA's "some fees in, some fees out" finance charge and APR disclosure scheme could be improved. However, debate is considerable about the extent of reform that is desirable and about what form the new rules might take. Any reform of the finance charge and the APR should satisfy two tests: Calculations and disclosures should be simpler, and the disclosures should be more meaningful for consumers.

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21 In examinations of state member banks conducted by the Federal Reserve between 1991 and midyear 1997, the finance charge disclosure for closed-end credit was the most common violation of Regulation Z. Data from the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency indicate, on average, comparable experience.

22 For a loan subject to rescission, if material TILA disclosures are not delivered or if they are inaccurate, a consumer's right to rescind may extend beyond three business days, for up to three years. If the consumer rescinds the transaction the creditor must refund all interest and fees paid by the consumer (although the creditor is entitled to the repayment of any outstanding principal). See chapter 5 for a further discussion of rescission.

23 15 U.S.C. § 1601 (Supp. II 1996). The 1995 Amendments provided additional tolerances for errors in the calculation of the finance charge (and the APR), so that the mischaracterization of fees with small dollar amounts would not result in potential class action claims for money damages or, in general, the cancellation of transactions. Lower tolerances apply when consumers seek rescission as a defense to foreclosure.

For example, reducing or eliminating the "some fees in, some fees out" finance charge rule would simplify compliance for creditors. However, if the resulting finance charge and APR are not more meaningful as a shopping tool for consumers, reform fails.

c. *Required-cost of Credit Test.* A test that defines the finance charge and APR as "the costs the consumer is required to pay to get the credit" is consistent with the purposes of TILA and provides a consistent basis for determining what is and what is not a finance charge. Under this approach, the finance charge would include (and the APR would reflect) costs required to be paid by the consumer to obtain the credit. It would include many fees required by the creditor and currently excluded from the finance charge--application fees; real estate closing costs, such as for appraisals, document preparation, and property title services; fees paid to public officials to record security interests; and other costs. In addition, the required-cost test would capture other costs such as insurance required by the Federal Housing Administration to obtain an FHA-insured loan. Mortgage broker fees would continue to be included. Fees for optional services, such as premiums for credit life insurance, would to be excluded.[24] Hazard insurance would also be excluded because the cost depends in large part on consumers' choices unrelated to the credit transaction. A chart in appendix C illustrates how the required-cost approach compares with the current rules.[25]

Other possible approaches to reform provide varying magnitudes in the "inclusiveness" of costs. A "cost of transaction" test would include in the finance charge and the APR items unrelated to financing, such as for sales tax or all items listed on HUD's settlement statement and paid by the borrower (but not the seller). It would more closely conform TILA to RESPA and would meet the spirit of harmonizing and simplifying the two acts. But it would change the emphasis of TILA's disclosure rules away from the cost of credit to costs associated with, for example, the underlying home purchase transaction.

A "consumer-pay" approach is somewhat narrower and would include in the finance charge and APR optional and other costs--such as for premiums for optional credit life insurance or owner's title insurance. While the consumer-pay approach offers a more complete price tag for the consumer than the current disclosure, it does not readily permit consumers to compare credit costs because the credit cost is combined with optional expenses, which could vary among creditors and by consumers' choices. TILA's current approach--providing additional cost information about such charges without adding them to the finance charge or the APR--seems more consistent with TILA's purposes.

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[24] Currently, premiums for credit life insurance purchased at the option of consumers are excluded from the finance charge only if creditors provide certain disclosures about the cost and optional nature of the product.

[25] The required-cost approach would provide certainty for creditors in calculating an accurate finance charge and APR, although some differences could arise over time about whether a particular cost is required by the creditor or is properly excludable from the finance charge. In such circumstances, a creditor could disclose a particular charge as a finance charge and avoid liability under TILA.

A more limited approach would be to include only interest and "interest substitutes" in the finance charge and APR. An interest substitute would include, for example, discount points, which are paid at loan closing in exchange for a lower interest rate over the loan term. The term "interest substitute" would need to be defined to ensure the uniform treatment of costs tacked onto payments, such as "monthly service fees" or "annual fees," and could result in continued murkiness about what should be included and what should be excluded. Also, consumers may find such a narrow definition to be unhelpful in comparing credit costs since some costs associated with credit would not be included in the finance charge and the APR. Creditors could advertise a low APR, yet impose fees that would not be captured in the rate.

*3. **Effect of Possible Changes to the Finance Charge and the APR.*** This segment discusses some effects of a required-cost test for determining the finance charge and the APR.

a. Magnitude of Changes in the Finance Charge and APR. In considering changes to the finance charge and APR, one question is how much the change might increase rates (disclosed or advertised). Is the increase likely to be so dramatic that consumers would perceive this as a material change in market interest rates? The answer appears to be no. Figure 1. illustrates the impact of modifying current TILA's finance charge and APR to reflect "the costs the consumer is required to pay to get the credit."

Figure 1. Effect of modification to the finance charge on the APR*

Approaches for finance charge disclosure	**APR** (Percent)
Current TILA	7.20
"Required-cost"	7.52

*For a $100,000 loan, with a thirty-year term a fixed interest rate of 7 percent, $2,000 in discount points; $3,000 in required closing costs (title, appraisal); and $1,000 in costs for optional services; all costs financed.

b. Transactions Covered by the Home Ownership and Equity Protection Act. HOEPA provides special protections to consumers in the case of certain home-secured loans with rates or fees above specified amounts.[26] The rate-based test for a HOEPA-covered loan is met if the APR at the time of closing exceeds by more than 10 percentage points the yield

[26] For a HOEPA-covered loan, creditors must provide abbreviated disclosures three days before consummation and may not include in the loan agreement certain provisions such as payment schedules that call for a balloon payment if the loan matures in less than five years. HOEPA's disclosure requirements are discussed later in the chapter; its substantive protections are discussed in chapter 6.

on Treasury securities having a comparable maturity to the loan.[27] The dollar-based test is met if the total points and fees exceed 8 percent of the loan amount or a certain dollar figure, whichever is greater. (The dollar figure is adjusted annually; for 1998 it is $435.) Fees included in the dollar-based calculation are "finance charges" (other than interest); closing costs paid to the creditor or an affiliate, even if they are excluded from the finance charge (appraisals, for example); and all compensation paid by consumers to mortgage brokers.[28]

Without corresponding changes to HOEPA, changes to the finance charge and the APR could increase the number of home-secured loans covered by HOEPA. To the extent that the finance charge becomes more inclusive, more loans may be covered by the act. For example, closing costs paid to independent settlement service providers currently are not included in HOEPA's "points and fees" calculation or in the APR. These fees are sometimes substantial, and when combined with other finance charges could trigger HOEPA coverage.

c. *Preemption Issues*. Many state usury laws are tied to TILA's finance charge and APR concepts. Depending on the magnitude, a change in these concepts could affect whether certain loans remain permissible under state law. Federal laws preempt state usury laws for first-lien loans secured by real estate.[29] However, to the extent the APR becomes more inclusive, creditors might be limited in the fees they currently charge for other home-secured loans. Without changes to the state laws (or broader federal preemption), this could significantly affect the way creditors price their loan products.

4. ***Recommendation***. The Board and HUD believe consumers will benefit from having a disclosure that includes the full cost of credit, not just the interest charged in connection with the loan. Moreover, having a single figure benchmark--the APR--that is simple to use allows consumers to evaluate competing products with one variable. The Board and HUD recommend that the APR be retained as a benchmark and that the interest rate on the note be added as a new disclosure. Disclosing the two figures together, along with an explanation of the APR, should improve consumer understanding of the significance of the APR and make it more useful. (See appendix A for an illustrative form.)

A more comprehensive definition of the finance charge under TILA would require significantly fewer judgment calls by creditors about whether a particular fee is a

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27 HOEPA authorizes the Board to adjust the rate-based trigger by a margin of 2 percentage points (decrease the trigger to 8 percentage points over Treasury securities of comparable maturity or increase the trigger to 12 percentage points).

28 HOEPA's dollar-based test is generally considered to be complicated and is discussed in appendix D.

29 12 U.S.C. § 1735f-7a (1994 & Supp. II 1996).

finance charge. The Board and HUD believe that the finance charge should be defined to include "the costs the consumer is required to pay to get the credit." Under this approach, creditors would have a clearer rule and reduce creditors' liability concerns. The changes should also make the disclosures more useful for consumers by providing a more accurate and reliable measurement of the cost of credit.

C. The Amount Financed

In addition to the finance charge and APR, TILA's disclosure of the "amount financed" should be considered as part of any mortgage lending reform.

1. Current Law. The amount financed is intended to represent the "amount of credit of which the consumer has actual use." It is the total amount the consumer is borrowing, including any costs that are financed, minus any finance charges (origination fees, for example) that are withheld from the proceeds (referred to as prepaid finance charges).[30] To illustrate, assume a consumer applies for a $20,000 loan for home improvements, based on the amount on the equity in the house. Origination fees of $2,000 (prepaid finance charges) would result in an amount financed of $18,000. But the consumer might have to pay additional fees of $2,000 in closing costs such as for title insurance, appraisals, and the like--which are not finance charges, and which would further reduce the consumer's proceeds to $16,000. A consumer who signs a note for $20,000 and receives $16,000 may not easily understand a disclosure that $18,000 is the amount of the credit available to him.

Under TILA, consumers have the right to request an itemization of the amount financed; for mortgage transactions subject to RESPA, creditors may provide RESPA's good faith estimate of closing costs (and the settlement statement if redisclosure is required) in lieu of TILA's itemization of the amount financed.[31] The RESPA disclosures give detailed information about the loan transaction, including funds paid to the consumer and closing costs paid to the creditor and third parties. However, neither the GFE nor the settlement statement identifies which of the disclosed fees are included in TILA's "amount financed," giving the consumer no information as to how the figure was derived.

2. Recommendation. The amount financed might be improved; however, the Board's recommendation is to drop it entirely for mortgage transactions. The Board believes the amount financed is probably not a useful disclosure for mortgage lending. Its primary benefit is that it allows supervisory agencies to easily determine whether the APR on a

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[30] 15 U.S.C. § 1638(a)(2)(A) (1994).

[31] 15 U.S.C. § 1638(a)(2)(B) (1994). The itemization identifies amounts (1) paid to the consumer (such as by a check from the creditor), (2) credited to the consumer's account (such as paying off an existing debt with the creditor), or (3) paid to third parties (such as the appraiser or the title insurance company).

transaction is calculated properly. Highlighting the loan amount on the note on the disclosure would be more helpful to consumers.

D. Other Key Disclosures under the Truth in Lending Act

TILA requires creditors to disclose not only costs but also other significant terms of closed-end credit transactions, such as whether prepayment or late payment penalties may be imposed, the right to have a home-purchase mortgage assumed by a subsequent purchaser, whether a loan has a demand feature or has a required deposit condition, and any security interest taken in property. Consumers appear to want only some of this information on a mortgage cost disclosure statement. Focus group participants who commented on the current TILA and RESPA disclosure forms found some disclosures--late fees and the ability to prepay without penalty, for example--more helpful than others.

The textual disclosures required by TILA reflect a decision about which loan terms may be important to consumers, although these items typically must be included in the loan documents regardless of federal law. To simplify the TILA disclosure scheme, some textual disclosures that are less likely to be the focus of consumer shopping could be eliminated while others may be enhanced. For example, it seems important that any mortgage disclosure scheme clearly inform consumers that their home is securing a loan. Although the information may appear obvious in the home-purchase context, its disclosure is important for consumers who may be unaware that the $5,000 debt consolidation loan or the loan for aluminum siding will result in a mortgage on their home. Consumer comprehension may also be improved by small format changes that plainly tell consumers "Your home is the security for this loan. If you do not make your payments, you may lose your home."

Disclosing the total closing costs on the TILA disclosure statement in the "Fed box"--which highlights several key cost disclosures--would be helpful to consumers shopping for a loan. Participants in the Board's focus groups and others favored having a disclosure on the TILA statement indicating the amount of money they need to close the loan. The disclosure forms in appendix A illustrate a revised and streamlined version of a TILA disclosure statement that has been combined with RESPA disclosures.

E. Home Ownership and Equity Protection Act of 1994

TILA imposes disclosure requirements and contractual limitations on creditors in connection with HOEPA-covered loans. HOEPA required the Board to hold public hearings on the law's effectiveness in protecting the rights of consumers, and low income consumers in particular. An overview of the hearings and findings concerning substantive protections and enforcement are discussed in chapter 6. Issues raised at the hearings concerning coverage, liability concerns, exemptions, and rulewriting authority are discussed in appendix D.

HOEPA layers disclosure and timing requirements onto the requirements already imposed under TILA for home-secured transactions. (Possible improvements to HOEPA's timing requirements are discussed in chapter 4.) Creditors must provide abbreviated disclosures to consumers three days before a HOEPA-covered loan is closed. The disclosures provide that consumers are not obligated to complete the transaction, remind borrowers that they could lose their home if they fail to make payments, and state a few key cost disclosures, including the APR, the amount of the regular payment, and, if the loan has a variable rate, a "worst case payment" if rates increase.

The Board received information about the effectiveness of HOEPA disclosures at its public hearings and in written comments. Creditors and consumers agreed that consumers are aided by HOEPA's modest disclosures. Creditors noted, for example, that receiving information about the APR and the monthly payment three days before closing eliminates surprises at the closing table when costs have changed from quotes provided during the application process. However, creditors conveyed a general notion that HOEPA disclosures are more redundant than informative, and questioned their benefit in relation to the compliance costs associated with providing them. Consumer representatives applauded the disclosures as a necessary first step but indicated that additional information about closing costs, broker fees, and premiums for credit life insurance was needed.

HOEPA's minimal disclosures--the warnings, the APR, and the regular and "worst-case" monthly payments--are helpful. If HOEPA were not in place, creditors could provide cost disclosures for these loans at closing instead of three days in advance.

The shortcomings of HOEPA's disclosure provisions center on the consumer's inability to appreciate and understand the information provided.[32] In some instances, these shortcomings could be addressed. For example, the Board believes that the purpose of HOEPA disclosures--to alert consumers about the nature of the transaction--remains a valid goal, and that special disclosures for HOEPA-covered loans should be provided to consumers, modified somewhat from the current requirements. These disclosures could be provided along with other TILA disclosures; however, to highlight these disclosures, the Board believes they should be segregated from other TILA disclosures and placed first in any combined disclosure document.

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[32] Creditors and consumer representatives described a trusting population of borrowers--financially unsophisticated individuals and the elderly--who may indeed receive a document disclosing a 24.00% APR, but not understand what that figure represents or whether that rate is competitive in the marketplace. Some consumers are confronted with disclosures written in English when negotiations were conducted in the consumer's native language. Consumer representatives also observed that HOEPA loans, like all real estate-secured transactions, involve a daunting amount of complicated and technical information. Particularly for some HOEPA borrowers, there is too much information for them to absorb, particularly in the "hurry, hurry, sign here" environment of a typical home-secured loan closing.

The content of the special disclosures that accompany a HOEPA-covered loan should continue to be a combination of textual advice and cost figures. The text of the warnings is currently prescribed by the statute; the law should be changed to allow flexibility through rulemaking and public comment on model clauses that might result in more user-friendly messages. Consumers should continue to be advised that they are not required to complete the transaction (and the consequences of nonpayment). Further, consumers should be plainly alerted that, due to the rates or fees charged for their loan, special disclosures and protections are being provided. Adding advice about seeking alternative financing, perhaps including HUD's toll-free number for housing counselors, should also be considered.

Because TILA's cost disclosures would be provided at the same time under the Board's proposal--three days before the closing--an APR on the HOEPA disclosure seems unnecessary. However, the Board recommends retaining the periodic-payment disclosure, and requiring placement of the consumer's monthly income next to the disclosed monthly payment. This addition addresses two concerns: The stark side-by-side comparison would assist consumers in analyzing their likely ability to meet the loan payments; and the disclosure would act as a check against "padding" income on applications. (See appendix A form A-8 for an illustrative disclosure.)

Chapter 3. Improving the Disclosure of Settlement Costs

Should Creditors be Required to Provide Firmer Quotes for Closing Costs Disclosed under RESPA?

It is a common goal of HUD and the Board to promote comparison shopping for mortgage credit by providing consumers with reliable costs they can compare among creditors and products. RESPA requires creditors to list on the GFE all costs they anticipate the consumer will have to pay in connection with closing a loan.[33] The GFE is provided to a consumer within three days after application. The settlement statement containing the actual costs is provided at closing and, upon the borrower's request, will be provided one day prior, but it may not be complete or accurate.

There are few incentives under RESPA for compliance with its disclosure requirements since there is no liability for errors on the GFE or the settlement statement. Therefore, from the creditor's standpoint, little (if anything) needs to be done to simplify or improve the GFE as a disclosure.

From the consumer's perspective, however, much could be improved. Generally the costs disclosed on the GFE are close to the actual costs, but not always. Consumers report many instances in which the costs disclosed on the GFE were significantly lower than those actually charged at closing. They also report cases in which some fees charged at closing were completely left off the GFE. To the extent these discrepancies exist, they make the GFE unreliable as a shopping tool; consumers cannot effectively compare settlement service costs if they cannot rely on the costs that are initially disclosed.

A. *Current RESPA Cost Disclosure Scheme*

RESPA requires creditors (or mortgage brokers) to provide all applicants for "federally related mortgage loans" with an estimate (the GFE) of the amount or the range of charges for specific settlement services in mortgage transactions.[34] These charges include creditor-imposed fees, such as loan origination fees; charges by third parties, such as appraisal or title insurance fees; and amounts the consumer is required to put into an escrow account for items such as property taxes or insurance. (See appendix A form A-2 for a sample of the current GFE form.)

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[33] 12 U.S.C. § 2601(b)(1) (1994 & Supp. II 1996).

[34] For open-end credit lines, HUD defers to the Board's disclosure rules under TILA. Generally speaking, a "federally related mortgage loan" includes most consumer loans that are secured by one- to four-family units.

The GFE provided within three days after application gives consumers an idea of the services required to close the loan and the total amount of closing costs. It allows consumers to understand how the total amount of closing costs will be allocated. It provides an opportunity for consumers to shop for some of the services (for example, settlement agent or title insurer). At settlement, consumers receive a second RESPA disclosure--the uniform settlement statement (the HUD-1)--that enumerates the final costs associated with both the loan and, if applicable, the purchase transaction. (See appendix A form A-3 for a sample of the current settlement statement.)

HUD has interpreted RESPA to require that the GFE cost disclosures must bear a reasonable relationship to the actual charges. RESPA does not impose liability on a creditor for an inaccurate or incomplete estimate, however, or for failing to provide one. The figures disclosed on the GFE need not be firm or guaranteed. Thus, there are few incentives for creditors to incur costs to increase accuracy. In some transactions, unexpected closing charges may result from unanticipated events or circumstances. In other cases, however, actual charges may be higher because the estimates may not have been prepared with sufficient regard for their accuracy.

The Board and HUD have considered a number of ways for making closing costs more reliable for consumers and believe that two methods--guaranteed costs (with the possibility of exemption relief from § 8 of RESPA) and a GFE with an accuracy standard such as a tolerance--offer a feasible approach for improving the shopping disclosures that consumers receive while minimizing creditors' compliance burden.

B. Guaranteed Closing Costs

One means of ensuring that consumers receive an accurate disclosure of loan closing costs is for creditors to guarantee them. The guaranteed-cost option is being advocated by various segments of the mortgage industry including many of the nation's largest creditors. According to these creditors, consumers do not shop for individual settlement services. They say that consumers are more interested in the overall price and that consumers would shop for overall price if all they needed to compare was a single guaranteed price for required settlement services. To arrive at a price, these creditors envision entering into volume-based contracts with affiliated and other settlement service providers for such services as appraisals, and "packaging" all the services needed for the loan.[35] They believe that by doing so they will be able to secure discounts that could ultimately be passed on to consumers. Packaging services will keep costs down more effectively than RESPA's anti-

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[35] As used in this report, the term "affiliate" broadly refers to business relationships among related or associated entities and generally does not refer to any specific statutory definition.

kickback provisions, they say, because it will better enable consumers to comparison shop and will encourage creditors and others to package competitively and to pass along discounts.

To package services, however, creditors and others perceive the need for relief from § 8 of RESPA and assert that, if they are willing to guarantee costs, they should be entitled to relief.[36] Section 8 prohibits kickbacks and referrals and unearned fees. But the statute, they say, gives no clear guidance on how to determine when a payment has been earned for goods or services (which is permissible under RESPA) or is compensation for a referral (which is illegal and subject to criminal sanctions). In particular, creditors say it is not always clear when providing a volume-based discount to a creditor or other settlement service provider is considered payment for the referral of business. In addition, the act prohibits requiring the use of an affiliated settlement service provider except in limited circumstances, which can be an impediment to packaging services. Because of the uncertainty about how § 8 will apply, proponents of packaging argue that they cannot offer consumers a package of services without a statutory exemption from § 8 for any service included in the guaranteed cost.

Critics of a guaranteed-cost approach include small creditors and independent settlement service providers such as appraisers and title agents. They cite two major concerns. First, they say that the only way a creditor could guarantee costs and remain competitive is by packaging services; and they express serious concern about the ability of smaller, unaffiliated institutions and other settlement service providers to arrange packages and compete in such an environment. Second, they believe that a packaging system would drive prices up and unduly restrict consumer choice. They assert that consumers do in fact shop for settlement services, that prices for these services are currently competitive, and that lifting the § 8 restrictions will harm rather than help consumers because, given the market power of the larger companies, it is questionable whether any savings from packaging would be passed on to consumers.

Consumer advocates generally favor the guaranteed-cost approach but express concern nonetheless. Although they believe that guaranteeing closing costs has value, they note that these costs are only a small portion of the overall cost of a mortgage loan. They say that consumers need a firm commitment not just on the closing costs but also on the interest rate and any points; otherwise consumers cannot truly comparison shop for the best loan. Consumer advocates also worry that unless the interest rate and points are guaranteed, some creditors may be tempted to increase them if, after providing the consumer with a guaranteed-cost quote, they find that the costs are in fact higher than anticipated.

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[36] 12 U.S.C. § 2607 (1994 & Supp. II 1996). Section 8 of RESPA prohibits referral fees, fee splitting, and unearned fees, which creditors assert is a major obstacle to guaranteeing closing costs. A detailed discussion on § 8 is included later in this chapter.

1. Methods for Guaranteeing the Closing Costs. Creditors could arrive at a guaranteed amount for closing costs by any method they chose. For example, they could review their settlement statements for preceding years and base the guaranteed price on an analysis of past transactions, current trends in the market, and fees charged by the service providers. Or, creditors might enter into contracts with service providers for set prices either by transaction or by time period. For example, a creditor could contract to have XYZ Appraisal Company complete all its appraisals for the next six months for $300 each. The creditor could rely on that contract price in pricing the package of guaranteed costs to the consumer. (See appendix E for an economic analysis of "packaging.")

With the costs negotiated in advance, creditors could disclose the cost for the package early in the mortgage shopping process with confidence. Creditors that contract with some, but not all, third-party service providers could provide the single cost disclosure based on a hybrid of the average-cost and packaging methods. Whatever method the creditor used, a creditor that guaranteed costs could not charge a consumer an amount that exceeded the quoted total amount.

Creditors currently do not package because they have insufficient economic incentive in light of potential liability for violations of RESPA's § 8, which could stem from any volume discounts they might arrange with service providers. To facilitate guaranteed costs, fees paid and arrangements entered into by creditors and other settlement service providers could be exempt from § 8 of RESPA so long as certain conditions were met. Those not meeting the conditions would remain subject to § 8.[37]

2. Costs Included in the Guaranteed Closing Costs. A guaranteed-cost disclosure would promote comparison shopping by providing consumers with a price for nearly all the services required by creditors to close the loan. This figure could then be used

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[37] The Bank Holding Company Act Amendments of 1970 (BHC Act) and the Home Owners Loan Act, as amended, also contain restrictions that prevent banks and thrifts from tying packaged settlement services to their mortgage loans. The BHC Act's anti-tying provisions prohibit banks, as defined in the Act, from conditioning the availability of credit or from varying its terms on the condition that customers purchase another product or service offered by the bank or any of its affiliates. See 12 U.S.C. § 1971 (1994) and 12 U.S.C. § 1464(q)(1) (1994).

If § 8 of RESPA is amended to allow creditors to require the use of affiliated settlement service providers, relief should also be granted to lending institutions covered by statutory anti-tying provisions to avoid placing them at a competitive disadvantage compared to nonbank creditors, such as mortgage companies. Relief should also be extended to companies with grandfather rights to own a so-called "nonbank bank," savings and loan associations, and certain institutions that are not "banks" within the meaning of the BHC Act, since the statutory anti-tying provisions apply to them as well. See 12 U.S.C. § 1464(q)(1) (1994), and 12 U.S.C. §§ 1843(f)(9), 1843(h) (1994). Any regulatory relief would require coordination among the bank regulatory agencies.

by the consumer to compare products among creditors. (See appendix A form A-4 for an illustrative disclosure of the guaranteed-cost approach and form A-5 for the applicable HUD-1.)

Guaranteed costs would capture all charges for creditor-performed services, such as application, underwriting, and origination. They would also include third-party fees for such items as surveys, appraisals, credit reports, and mortgage broker services.[38] Official fees associated with filing or recording a mortgage or release which can be determined easily would be included. To ease compliance for creditors, charges included in the guaranteed costs could generally track TILA's definition of finance charges.

As with the finance charge, not all fees would be captured in the guaranteed costs. For example, the cost of hazard insurance would not be included because the cost depends upon consumers' choices unrelated to the credit transaction (such as the purchase of additional personal property or liability coverage).[39] Charges assessed in a comparable cash transaction, such as taxes, also would be excluded from the guaranteed amount (although they would continue to be disclosed as "other costs"). Alternatively, HUD suggests that some costs excluded from TILA's finance charge, such as for recording a deed, be included in the guaranteed cost amount.

Some charges like points and per diem interest, which fit the definition of a finance charge, would be excluded from the guaranteed costs. These amounts as well as

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[38] Including mortgage insurance and similar charges in the guaranteed amount (such as the FHA funding fee, which allows a creditor to minimize risk for a low-down payment mortgage) is more difficult. These costs are based on the ratio of the loan amount to the value of the property, and cannot be finally determined with certainty until the creditor knows the property value. For example, while creditors can look at the sales contract (for home purchases) or the recent tax assessment (for non-purchase transactions), the property value typically is confirmed by an appraisal later in the application process. However, mortgage insurance premiums or similar fees are required costs of obtaining the loan and therefore should be included in the guaranteed-cost package.

One option would be to allow the creditor to give a rate schedule that shows the unit-cost of costs such as PMI premiums depending on the loan amount. If the loan amount changes, the creditor could increase or decrease the guaranteed costs as reflected in the rate schedule.

[39] Hazard insurance, which protects against loss of or damage to property, is required by the creditor usually in an amount equal to the loan. Numerous factors are considered in determining the premium amount, many of which are based on the borrower's decisions. The premium for hazard insurance may increase depending on whether the borrower elects to include additional protection against loss of or damage to personal property. The cost will also vary depending on whether the borrower chooses to receive the replacement cost or the fair market value cost of the lost or damaged property, and on whether liability coverage is included.

To enhance comparability among loans, creditors could be required to estimate the cost of hazard insurance based on the minimum coverage that the creditor requires. Although this amount could increase at closing depending on options or riders included by the borrower, the disclosed estimates would generally be in the same range, assuming that the loan amount remains constant.

optional costs would be separately disclosed. (See detailed discussion on these costs later in this chapter.)

A guaranteed cost scheme raises two significant issues: (a) Should the closing cost be itemized by service and amount, and (b) should consumers be permitted to substitute service providers?

a. Itemizing Guaranteed Closing Costs by Service and Amount. Consumers often like to know what services are included in the costs they are paying in connection with the loan.[40] Participants in the focus groups conducted by the Board rated the GFE form highly, citing the itemization of the closing costs as a primary factor. Itemization may also be useful for comparing different loans that quote the same "fixed" amount for up-front charges but vary in services that may benefit the consumer.[41]

The extent to which itemization benefits consumers must be weighed against creditors' concerns about itemizing services. Some creditors state that it is difficult to know at the outset which services will be needed in a particular loan transaction. For example, while a property appraisal is required in most mortgage loan transactions, a professional pest inspection may be required only if there appears to be the possibility of an infestation.

If required to itemize, creditors that guarantee costs may list services that are customarily required to close the loan. In the end, however, fewer or more services than those originally listed may be performed. While consumers would be responsible for paying the guaranteed amount, they may perceive--where fewer services are performed--that they are paying for services that were not delivered.

Moreover, a requirement for full itemization of services might lead some creditors to create a long list, including amortization schedules, coupon books, and numerous other items that frequently are provided at little or no cost, to justify high closing costs. A comparison of laundry lists of services among creditors could ultimately be confusing to consumers and hinder their evaluation of different loans. Other entities expressing interest in offering packages indicate that itemization would help to ensure that the services required by creditors for "acceptable" packages are comparable to the services offered by creditors in their own packages.

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[40] Similarly, consumers may want to know the identity of the service providers for two reasons: to ensure quality and, if creditors permit the substitution of service providers, to evaluate whether substitution is in their interest.

[41] For example, if creditor A offers lower guaranteed costs than creditor B, the consumer may choose creditor A. But assume the consumer wants a survey. Without knowing that creditor B's guaranteed costs include a survey and creditor A's do not, the consumer may choose what appears to be the better deal. In the end, however, the consumer would pay for creditor A's guaranteed costs plus an extra amount for a survey.

To minimize these potential problems, creditors could disclose the guaranteed amount for closing costs without any elaboration on the early disclosure, and subsequently provide a list of services actually performed on the final settlement disclosure. Alternatively, creditors could provide a list of services that might be performed on the early disclosure with an explanation, if appropriate, that all items may not be performed, and then indicate on the settlement statement the services actually performed.

Another means of addressing these issues is to require that creditors disclose "core services," which could be defined by statute or regulation. These would be the services typically required in a mortgage transaction that consumers expect to have performed, such as appraisal, title examination, and flood certification. Itemizing other services would be optional. This approach would give consumers some common information to compare packages and shop.

An additional issue is whether the *cost* of services should be itemized. Participants in the Board's focus groups expressed a desire to know how the costs were allocated, despite the fact that they were unclear as to how they would use the information. Disclosing the cost of each service could present problems, however, particularly where creditors or other packagers enter into volume-based contracts. For example, creditors or others might contract with third-party service providers to perform services for a lump sum amount, or might even out the overall price of settlement services by offsetting a higher-priced service against a lower-priced service. Proponents of a guaranteed-cost approach contend that for the approach to work, creditors should not be required to itemize each of the services and the individual costs.[42]

b. Substituting Services in the Guaranteed Closing Costs. Another issue is whether the consumer should have the right to substitute a service provider for some or all of the services included in the guaranteed amount.[43] If the consumer has the right to substitute service providers, then it would be necessary to disclose to the consumer which ones could be substituted and how much of the guaranteed costs these services represent.[44]

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[42] These creditors state that when they provide the disclosure they may not know precisely which services they will require, and they fear liability if they disclose services they ultimately choose not to perform. They also assert that even at closing they may not know the cost for each service. For example, if a creditor contracts with an appraiser to do all the creditor's appraisals for six months for a flat fee, the creditor will not know the actual cost per appraisal until the six months have passed and the creditor can divide the amount paid by the number of appraisals performed.

[43] Also, some states prohibit creditors from requiring use of specified providers for services such as title and property insurance.

[44] Regulation X currently requires creditors to give consumers a notice if particular service providers must be selected from a creditor-controlled or approved list. 24 C.F.R. § 3500.7(e)(4) (1997).

Creditors generally argue that allowing the consumer to substitute service providers unconditionally for any of the services included in the guaranteed amount could compromise a creditor's ability to ensure that its interests are protected. Creditors state that the services performed are for their benefit, not the consumer's, and therefore service providers should be subject to the creditor's approval. For example, an appraisal is generally considered to be for the creditor's benefit, to assure that the collateral will support the loan.[45] Also, a system that would permit consumers to substitute providers likely would require creditors offering a package of services to adjust the cost of the guarantee and allocate a price to the particular service for which the consumer has selected a provider.

3. *Determining Who May Offer "Packages" of Settlement Services.* Affinity groups, title companies, realtors, and others have expressed interest in offering packages of settlement services to consumers under the guaranteed-cost approach. If only creditors (those that traditionally have originated mortgage loans) are allowed to package, competition would be unnecessarily restricted and consumers could be deprived of lower prices. However, because settlement services generally are performed for creditors' benefit, creditors voice concern about the possibility of having to accept unconditionally any settlement service package selected by consumers.

A system could be established to address the concerns of both creditors and others. For example, any exemption under RESPA's § 8 could be available to creditors and other packagers. RESPA would define the requirements and entities wishing to qualify would need to meet all conditions. If the law's provisions required firm settlement costs and rate information for loans, packagers that are not also creditors would be obliged to affiliate with creditors or enter into arrangements with creditors to qualify for the exemption.

4. *Other Costs.* Costs excluded from the guaranteed closing costs could be disclosed as "other required costs" or as "optional costs." "Other required costs" include those costs that the consumer will have to pay at closing, but the amount of which creditors cannot be certain, such as per diem interest. Charges for per diem or "odd days" interest, which floats along with the interest rate, cover the time between the date of closing and the date interest begins to accrue for first regularly scheduled payment.[46] Because the date of

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[45] RESPA currently allows creditors to require that consumers use particular settlement service providers so long as the name and address of the provider are given to the consumer (generally on the GFE except in limited circumstances). However, creditors may not require consumers to use a settlement service provider with which the creditor has an affiliated business relationship, except for the creditor's chosen attorney, appraiser, and credit-reporting agency.

[46] As an illustration, if a loan closes on January 15 and the first monthly payment (due on March 1) begins to accrue interest on February 1, interest for the days between January 15 and February 1 is generally required to be paid at closing as per diem interest. Some creditors do not collect per diem interest at closing but add the amount to the first monthly payment.

closing and the interest rate can change the amount charged, this amount likely should be excluded from the guaranteed cost.[47]

"Optional costs" include fees that cannot be guaranteed by the creditor because the cost depends on whether the consumer chooses to purchase the service and on the level of service chosen. Examples include owner's title insurance and the consumer's own attorney.[48] A separate disclosure would indicate to the consumer that optional items do not have to be purchased to obtain the loan. This disclosure may also help prevent creditors from including charges in the estimate for items or services that the consumer may not wish to purchase.

*5. **Interest Rate and Points.*** Consumer advocates indicate that to assure that homebuyers have the necessary information to shop for and compare loan products, it is essential that firm interest rate and point information be offered along with guaranteed settlement costs. Consumer advocates note that settlement costs are only a small portion of the mortgage loan. They say that consumers need a firm commitment, not only on closing costs but also on the interest rate and points (if any) to effectively shop for the best loan.

These advocates also assert that, without a firm commitment, interest rates and points could be increased to defray settlement costs or realize additional profits. They express the fear that unwary consumers will be lured into particular loan products by inexpensive or below-market settlement cost packages; if settlement services are the only cost items that are guaranteed in the transaction, unscrupulous creditors could easily deceive the consumer and recover any lost profits by simply adjusting the rate or points charged on the loan. Consumer advocates believe that the benefit derived from guaranteed settlement costs could be negated by the creditor's ability to increase costs elsewhere in the transaction.

On the other hand, some creditors assert that it is not feasible to offer a firm rate and point quote without full underwriting. Creditors point out that underwriting is costly and time-intensive and that mortgage brokers and other retail originators cannot provide guaranteed rates that bind creditors early in the mortgage loan process. Other industry representatives assert, however, that requiring creditors to provide guaranteed rates and points along with guaranteed settlement costs is viable; they say that today's mortgage originators provide firm information to shoppers early in the process based on credit reports, usually without any assurance that the originator will receive compensation.

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[47] Creditors could be required to estimate an amount based on thirty days. Surprises for consumers at closing would be eliminated, since the amount actually collected would not be greater than the estimated amount (assuming no increase in the interest rate). Or creditors could be required to disclose the daily interest to allow consumers to recalculate actual amount as the date of closing becomes certain.

[48] As a practical matter the consumer may not make a final election until closing.

While HUD believes that consumers should be provided sufficient information at appropriate times to allow them to shop and make informed choices, creditors must be able to assure that they have adequate bases for their loans. HUD is aware of efforts under way to design means of providing consumers early and complete information on the cost of financing while assuring that the interests of creditors are appropriately served. Specifically, promising proposals are being advanced by consumer and some industry representatives where creditors after obtaining credit reports would provide consumers guaranteed rate and point information. This guarantee would be subject to appropriate conditions such as market changes in rates (where the rate and points are not locked) or verification of borrower information concerning the value of the collateral or the borrower's creditworthiness. HUD supports these and similar efforts because it regards the full costs of financing--including fees, rate, and points--as the information that is most useful to consumers to allow them to shop for a mortgage loan. HUD believes that it is essential that creditors and consumers alike continue working toward this end. HUD's recommendations support this position.

Accordingly, HUD proposes that to qualify for any exemption from § 8 of RESPA, interest rate and points should be guaranteed and disclosed along with guaranteed closing costs.

6. Issues under RESPA's Section 8. Creditors assert that § 8 of RESPA is a major obstacle to providing a single guaranteed price for closing costs. Section 8 prohibits referral fees, fee splitting, and unearned fees; however, it allows payments for services actually performed.[49] Section 8 provisions may prohibit certain arrangements between a creditor and a settlement service provider for volume discounts and various revenue-sharing arrangements, which are perceived as essential for packaging.

Section 8(b) of RESPA provides that no person is allowed to receive "any portion" of charges for settlement services, except for services actually performed. In interpretations of the statute and its legislative history, HUD has consistently held that the provisions of § 8(b) apply in various situations, such as where one settlement service provider (1) receives an unearned fee from another provider, (2) charges the consumer for third-party services and retains an unearned fee from the payment received, or (3) accepts any portion of a charge other than for services actually performed. HUD's regulation specifically provides that if the payment of a thing of value "bears no reasonable relationship to the market value of the goods or services provided," then the excess will be deemed to be unearned for

[49] Regulation X defines a "referral" as "any oral or written action directed to a person which has the effect of affirmatively influencing the selection by any person of a provider of a settlement service or business incident to or part of a settlement service...." 24 C.F.R. § 3500.14(f)(1) (1997).

purposes of § 8(b).[50] If volume or other discounts are not passed directly to the consumer and the creditor retains a portion of the charge, it can be argued that a violation of the prohibitions against unearned fees has occurred. For these reasons, creditors may hesitate to engage in any type of arrangement that could be perceived as improper under RESPA's criminal anti-kickback and unearned fee provisions.

Granting an exemption from § 8 for packaging would likely facilitate guaranteed-cost arrangements and induce competition. Competitive pressures, in turn, should serve to lower prices naturally, consistent with RESPA's purposes without the need for prohibitions against kickbacks, fee splitting, and unearned fees. An exemption for packaging could also obviate the need to regulate the reasonableness of fees paid to individual settlement service providers whose services are included in packages. If consumers are quoted a guaranteed price at a point in the process when they are still able to shop and compare products, then the reasonableness of fees for particular settlement services within the package is not relevant.

Offering an exemption from § 8 to encourage guaranteed loan prices would have other benefits. It could result in a simpler and more effective disclosure scheme that would facilitate shopping and enhance competition.

*7. **Disclosure Liabilities and Remedies***. If a guaranteed closing costs approach is made available to creditors, consumers would need to be informed, either by a disclosure or by a discussion of the rule in HUD's Special Information Booklet (discussed later in this chapter), of their right to be charged no higher fees (and in HUD's view, rates and points) at closing. If disclosures are not provided or if consumers are charged more than the guaranteed amount at closing, legal remedies should be available. Under current TILA rules, creditors are generally liable to consumers for actual and statutory damages for noncompliance, including failing to accurately disclose and failing to provide disclosures. Similar provisions could be adopted under RESPA. HUD specifically recommends establishing additional enforcement authority for RESPA generally, including remedies that can be sought by consumers, the states, and HUD. (See chapter 7 for a more detailed discussion of liability and remedies under RESPA.)

Another possibility the Board suggests is a remedy modeled after a "qualified written request" under RESPA.[51] For example, if consumers were charged an amount in excess of the guarantee at closing, they could close the loan without waiving their right to

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[50] Regulation X states that the term "thing of value" is "broadly defined," and then provides an illustrative list which includes monies, discounts, dividends, future credits, opportunities to participate in money-making programs, special bank deposits or accounts, and special rates. 24 C.F.R. § 3500.14(g)(2) (1997).

[51] See 12 U.S.C. § 2605 (1994 & Supp. II 1996).

send later a written demand for a refund of the excess. If the creditor failed to comply within a specified time period, the consumer could pursue statutory remedies including a private right of action against the creditor.[52]

D. A More Reliable Good Faith Estimate

A second way to provide consumers with more reliable information is to impose an accuracy standard on the GFE and establish remedies for noncompliance. The tolerance could be based on a percentage of the total estimated closing costs,[53] if the actual costs exceed the sum of the estimated costs and the amount of the tolerance, the creditor would be held liable. Alternatively, the tolerance could be limited to certain categories of costs, for example, costs not within the creditor's control; charges imposed directly by the creditor would have to be accurate.

In either case, an increase in costs resulting from a consumer's choice would not count against the creditor in determining whether the total closing costs exceeded the tolerance.[54] Neither would increased costs associated with specified changes to the transaction, such as an increase in the loan amount. But increased charges resulting from a creditor's decision (for example, to require a pest inspection after reviewing the appraisal) could not exceed the tolerance.

The potential liability for exceeding the tolerance would have to provide creditors with sufficient incentive to give accurate estimates, but not be so severe as to effectively require a guarantee of costs. The penalty could be set as a flat fee or as a percentage of the difference between the estimate and the actual costs.[55] HUD believes that

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[52] This remedy would enable consumers to pursue their rights without having to retain an attorney and incur additional costs.

[53] If a tolerance approach is adopted to provide more reliable estimates, the Board and HUD believe that additional study is required to set the tolerance so that it provides creditors with some margin for error but is not so expansive to make the estimates meaningless. For example, the tolerance could be based on a percentage of the total estimate for closing costs, such as 5 percent, but not as high as 25 percent. Other alternatives would be to base the tolerance on the loan amount, or to establish a set dollar figure.

[54] For example, if the creditor estimated $300 for the title insurance based on a list of required providers, but the consumer chose an title company that charged $400, the $100 difference would be subtracted from the total before determining whether the total exceeded the estimate plus tolerance. Similarly, negotiations between the buyer and seller regarding who would pay certain fees or points would not affect the GFE.

[55] One concern with taking this approach is that creditors could inflate the estimates, to give themselves additional room for error or to try to offset the amount of any potential penalty. However, the need to quote competitive prices should deter this practice. Any increased charges imposed on the borrower would be reflected on the final settlement statement and would be subject to scrutiny under § 8 of RESPA for unearned fees.

creditors should not be allowed to retain any monies received in excess of the tolerance. If the settlement statement indicates costs that exceed the tolerance, the revised remedies provided for violations of any of RESPA's provisions would be available.[56] (See chapter 7 for a further discussion of those remedies.)

Adopting an accuracy standard for GFE disclosures would require little or no change to the current GFE form. The GFE would retain the item-by-item listing of those costs that consumers are expected to incur in connection with closing. Because the closing costs would not be guaranteed, there would be no relief from § 8 liability. (See appendix A form A-6 for an illustrative disclosure under the GFE approach and form A-7 for the applicable HUD-1.)

E. Recommendation: Option to Guarantee the Closing Costs or Provide Firmer Good Faith Estimates

The Board and HUD believe that creditors should be required to provide consumers with firm quotes of the costs required to close the loan. Such a change would improve the current disclosure scheme by reducing the instances in which consumers may incur additional costs at closing. It would also improve the finance charge and APR disclosures, because many of the costs that go into those disclosures would now be firm.

The Board and HUD recommend that creditors and others be given a choice between guaranteeing closing costs and providing estimated closing costs that are accurate within a prescribed tolerance. Having this choice would provide flexibility to creditors and would allow the market to test the competing approaches to RESPA simplification. This approach would not force a complete change in the market; no creditor, large or small, would be required to enter into guaranteed arrangements. It would create an opportunity for the market to test whether guaranteed cost arrangements offer more economical and efficient means for consumers to obtain mortgage loans.

Specifically, the Board and HUD recommend that new requirements be established so that the GFE more accurately reflects the costs the consumer will incur in connection with closing. Tolerances or other means should be established and liability and enforcement provisions should be added to RESPA to help ensure that consumers are adequately protected.

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[56] Another possibility is that consumers could receive a worksheet along with the settlement statement that would allow them to calculate whether the tolerance had been exceeded, and if so how much was owed to them. Expanded liability also could be imposed on creditors that engage in a pattern or practice of making inaccurate estimates.

The Board and HUD recommend granting an exemption from § 8 of RESPA to those offering a package of settlement services at a guaranteed price. The agencies believe that any entity should be allowed to package settlement services. The central purpose of an exemption should be to improve the consumer's ability to shop effectively for a mortgage loan and thereby allow competitive forces to reduce the cost of financing a home. To carry out this purpose, HUD believes that an exemption from § 8 should be available to creditors and others that meet appropriate condition, including: offering consumers a comprehensive package of the settlement services needed to close a loan; providing consumers with a simple prescribed disclosure that gives the guaranteed maximum price for the package through closing; and disclosing the rate and points offered to the consumer for the loan, together with a guarantee that the rate and points will not increase, subject to prescribed conditions.[57] HUD believes that if consumers are required to pay a significant up-front fee to the creditor in order to obtain firm information, it serves as a deterrent to shopping.

Fees paid and arrangements within packages would be exempt from § 8.[58] Fees for referrals to or from the packager of settlement services would continue to be subject to § 8. For example, a realtor could not receive a fee for referring a consumer to a packager. Entities that do not meet the requirements of the exemption would be subject to § 8.

Consumers want to know what services they are purchasing. The Board and HUD believe that listing the services included in the guaranteed amount should be required on either the initial disclosure or, at a minimum, on the settlement statement. However, the Board and HUD do not believe that itemizing costs or service providers should be required, although creditors should be allowed to provide this additional information if they so choose.

F. HUD's Further Recommendations

HUD supports a balanced approach to simplifying disclosures as long as the consumer is protected. In addition, HUD maintains that the initial disclosure or accompanying documents should inform consumers of the functions of mortgage originators,

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[57] See the detailed discussion on § 8 earlier in this chapter.

[58] The exemption would apply only to the particular transaction in which the conditions were met; it would not confer general immunity on the packager for all its activities. For example, a creditor could use the guaranteed cost approach for all its variable-rate loans and the estimate approach for all its fixed rate loans. In such a case, the creditor would qualify for § 8 exemption only for the variable-rate loans.

and the requirement for escrow accounts and PMI. Under an improved GFE scheme, HUD also supports disclosure of mortgage broker fees.[59]

1. Transfer of Servicing Statement. Some consumers select a creditor because they prefer to do business with that party. RESPA requires creditors to provide consumers at application, or within three business days, information about the likelihood of the creditor's transferring the servicing of the loan to someone else and the consumer's rights if such a transfer occurs.[60] It is important for consumers to know (1) that the party providing the loan may not retain servicing of the loan and (2) the likelihood of a transfer of servicing.

Recent legislation has greatly simplified this disclosure to an abbreviated statement, "We (may/do not intend to/intend to) assign, sell, or transfer the servicing of your loan." The agencies suggest that the abbreviated statement be included on the initial combined disclosure.[61] While it would lose the prominence of being on a separate document, abbreviating the text and including the statement on the primary application disclosure could result in a more effective and useful disclosure for consumers.[62]

2. Special Information Booklet. RESPA requires creditors to provide a booklet that helps homebuyers understand the nature and costs of real estate settlement services. The agencies recommend that other parties participating in the loan transaction--for example, realtors, builders, or mortgage brokers--share responsibility for providing the

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[59] HUD's proposed mortgage broker rule requires a contract for the disclosure of a mortgage broker's functions and fees; the purpose was to relieve consumers' confusion and to disclose indirect fees. 62 Fed. Reg. 53,912 (October 16, 1997). HUD believes that reform efforts should be equally protective of consumers' interest. The proposed disclosure would still be appropriate under a scheme where the GFE was employed. Under the guaranteed cost scheme, however, where no specific fee amount is disclosed, the proposed statement of the broker's functions could suffice depending on the outcome of the reform process. See appendix F for a detailed discussion of HUD's proposed mortgage broker rule.

[60] 12 U.S.C. § 2605 (1994 & Supp. II 1996). The provision also requires specific notice by the current and new servicer in the event of a transfer. Regulation X provides model forms for these disclosures. Legislative amendments in 1996 reduced the required initial disclosure to a statement of whether loan servicing might be transferred in the future. In May 1997, HUD issued a proposed rule implementing this change, and retaining a statement that borrowers had basic rights regarding their account throughout the life of the loan, whether or not servicing was transferred. HUD has not completed this rulemaking pending the outcome of RESPA and TILA reform

[61] RESPA currently requires creditors to obtain from consumers an acknowledgement of receipt and understanding of the servicing disclosure; these requirements would be eliminated.

[62] The initial disclosure currently sets forth a statement of consumers' right to inquire about the servicing of their account, including any required escrow account, and to receive a response to their inquiry within 60 business days. HUD suggests that if this statement were no longer included in the initial disclosure, the statement could be added to the escrow account statements required under § 10 of RESPA. 12 U.S.C. § 2609 (1994 & Supp. II 1996).

Special Information Booklet to consumers early in the shopping process, such as before a consumer enters into any binding legal agreement.[63] (See chapter 4 for a discussion of possible changes to RESPA's timing rules.)

3. Information about Escrow Accounts. HUD believes the initial disclosure should inform consumers whether an escrow account is required for the loan. If an escrow account may be waived, the disclosure should tell the borrower what charges, if any, are applicable for waiving the creation of an escrow account or for terminating an account later. Given that the escrow account may be of economic value to the creditor or a subsequent servicer, some creditors charge the borrower higher initial fees or rates in return for not requiring an account, and the consumer should be so advised.

4. Information about Private Mortgage Insurance. HUD believes the initial disclosure should identify any PMI requirements applicable to the loan. Consumers are usually required to purchase PMI if the loan-to-value ratio of a mortgage is higher than 80 percent. The initial disclosure could clearly state whether PMI is required and whether it may be cancelled and the conditions. HUD has supported congressional proposals providing consumers with the clear right to cancel PMI; the disclosure should not be regarded as a substitute for these provisions. HUD supports establishing comprehensive remedies for violations of these provisions.

G. HUD's "Essential Reform" Package

Whether or not the Congress chooses to enact an exemption from § 8, HUD believes that improvements to the existing RESPA disclosure scheme are critical. HUD supports, at minimum, an "essential reform" package to simplify and improve RESPA-TILA disclosures that would:

- Require dissemination of educational booklets to consumers for various types of loan transactions--including refinancings and subordinate liens--early in the homebuying and mortgage process, for example, by requiring real estate agents or loan originators to provide settlement cost booklets to consumers at first contact.
- Combine and simplify the RESPA and TILA disclosure forms to be provided to consumers. The disclosure should also inform consumers of the functions of mortgage originators, and of the requirements for escrow accounts and PMI. Definitions for disclosures under RESPA and TILA should be coordinated to the greatest extent possible.

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[63] Mechanisms to enforce compliance with this disclosure responsibility should accompany the statutory revisions.

- Coordinate the timing of RESPA and TILA disclosures to the greatest extent feasible. HUD supports disclosure earlier than three days after application under an improved RESPA disclosure scheme to offer consumers a more useful shopping tool. HUD believes technology promises to make earlier disclosure possible for all loans. HUD agrees with the Board that the consumer should receive the settlement statement and any necessary redisclosure of rate-related information three days prior to closing.

- Require more accurate estimates of closing costs. Early disclosures of estimated closing costs within the control of the creditor should vary little from final costs. Tolerances or other mechanisms may be appropriate for costs outside the creditor's control.

- Establish new and simplified remedies to protect consumers against inaccurate disclosures and the failure to provide disclosures. RESPA's remedies should be expanded and simplified and its statute of limitations extended and standardized to ensure better consumer protection against RESPA violations. RESPA should have strengthened criminal sanctions and should include expanded injunctive authority and civil remedies. It should also provide for expanded remedies available through private causes of action.

Chapter 4. Delivery of Disclosures

Should the Timing Rules for Providing Cost Disclosures to Consumers be Changed (and Should Creditors be Required to Provide Disclosures Before Imposing Substantial Fees)?

The congressional mandate requires the Board and HUD to simplify and improve the timing of the disclosures under the two laws. The disclosure process would be simplified for creditors if the timing requirements for providing disclosures were made more consistent. It would be improved for consumers if the disclosures were given when they would be most useful.

This section explains the current timetable required under TILA and RESPA, describes some typical transactions, and then focuses on two key questions--(1) when should consumers receive disclosures (and any subsequent redisclosure) and (2) what, if any, fees can be charged before the disclosures are given to consumers. The following chart describes when the various disclosures are required to be provided by the statutes.[63]

[63] In some instances the timing is different under the applicable regulation. For example, Regulation X, which implements RESPA, allows the initial transfer of servicing disclosure to be provided within three days after application.

Figure 2. Timetable for Providing Disclosures Under TILA and RESPA.

Timing	TILA	RESPA
At or before referral		▸Affiliated business arrangement disclosure
At or before application	▸Home-secured lines of credit (HELOC) booklet & disclosure ▸Adjustable rate mortgage (ARM) booklet & disclosure	▸Initial transfer of servicing disclosure
Within three days of application	▸TILA disclosure (home purchase loans only)	▸HUD Special Information Booklet (home purchase loans only) ▸Good faith estimate (GFE)
Three days before closing/ consummation*	▸HOEPA loan disclosure ▸Reverse mortgage loan disclosure	
One day before closing/ consummation		▸HUD-1 settlement statement (if requested)
At closing/consummation	▸TILA disclosure (for all transactions except home purchase; for home purchase if change in terms) ▸Rescission notice	▸HUD-1 settlement statement ▸Initial escrow account statement (within 45 days of closing)
Post closing/consummation	▸ARM notice of rate & payment changes	▸Annual escrow statement ▸Transfer of servicing notice

A. *Timing of Disclosures in Home Purchase and Refinance Transactions*

Currently, in a typical home purchase or refinance transaction, the consumer receives RESPA or TILA disclosures at several different times. If a real estate agent refers the consumer to an affiliated service provider, such as a creditor, the consumer receives a disclosure describing the relationship between the entities at the time of the referral. If the consumer is interested in an adjustable-rate mortgage loan, the consumer receives a booklet describing these products (the ARM booklet) when the application is provided or before a non-refundable fee is charged.[64] Within three days after applying for a loan, the consumer receives the HUD Special Information Booklet (home purchase loans only), the initial transfer of servicing disclosure, the GFE (including any notice about required providers), and the TILA cost disclosure containing the APR and related information (home purchase only).[65] One day before closing, the consumer receives, upon request, a copy of the HUD-1 settlement statement filled out with as much information as the settlement agent has at that time.

At or before closing, the consumer receives another TILA disclosure if the information on the original disclosure has become inaccurate. (In the case of a refinancing, the consumer typically receives the TILA disclosure for the first time at or just before closing.)[66] At closing, the consumer receives a completed copy of the settlement statement, and for certain refinancings, a notice of the right to rescind. If an escrow account has been established in connection with the loan, the consumer receives an initial escrow account statement at closing or within 45 days after settlement.

B. Timing Changes to Initial Loan Disclosures

There are several ways in which the timing of the disclosures could be simplified or improved. For example, HUD's Special Information Booklet, which provides consumers with basic information about home buying and financing, is now provided at or within three days after loan application for home purchase transactions. That booklet could as easily be provided at application--when the Board booklets describing adjustable rate mortgage loans and open-end home-secured lines of credit, as applicable, are now given. Or, the HUD booklet could be given or offered earlier, such as when the consumer first contacts a creditor, realtor, or other settlement service provider. Either change would simplify the disclosure scheme for creditors by having the same timeframe for all three booklets and would improve it by providing educational material to consumers earlier.

A more significant change--from both the consumer's and the creditor's perspective--would be to modify the timing of the loan-specific cost disclosures. The Board and HUD believe that rapid advances in the use of technology (such as automated

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[64] Currently, HUD's Regulation X defines "application" as the submission of information, that identifies a specific property, in anticipation of a credit decision. The Board's Regulation Z adopts the same definition. Accordingly, consumers generally do not receive disclosures in connection with prequalification requests. The Congress may wish to consider whether disclosures are necessary at the prequalification phase.

[65] If the consumer applied through a mortgage broker, the TILA cost disclosure is not required to be given until three days after the creditor receives the application from the mortgage broker.

[66] If the refinancing is a HOEPA loan or a reverse mortgage, additional disclosures must be provided three days before closing.

underwriting) will allow creditors to provide firm loan costs, including the interest rate and any points, at increasingly earlier stages of the loan origination process.

Consumers need firm information early in the loan application process so that they can compare the products of one creditor or settlement service provider with another. If consumers receive firm information but it comes too late in the loan process, they will not have the opportunity to shop. Moreover, if the information is available but they must pay a significant fee to obtain it, consumers may be disinclined to seek comparable information from multiple sources.

In an ideal world, shopping for a mortgage loan would be like shopping for almost anything else. Consumers could find a loan product with features they liked (such as a low downpayment) and immediately be told what that loan would cost them. The reality, however, is that determining the price of a loan--particularly the interest rate and, to some extent, the closing costs--is currently more difficult than determining the off-the-shelf price of, say, a television set. To determine the interest rate and points for the loan, the creditor generally must evaluate the consumer's creditworthiness. To determine the other costs to close the loan, the creditor must ascertain what services are needed and their price.

Advances in technology continue to make these determinations easier. Greater use of technology makes more accurate information--including credit information--available to creditors more quickly, resulting in consumers' receiving reliable disclosures earlier. As technology advances, loans can be underwritten more promptly because of new capabilities and the prevalence of automated systems. And because automated systems free staff resources for cases that require manual underwriting, many creditors can be expected soon to have the ability to offer early interest rate and point information.

RESPA requires creditors to provide the GFE to consumers within three days after application, and many creditors currently provide them even earlier based on their knowledge of settlement costs. Under the Board's and HUD's recommendations, creditors or others that choose to package services could provide--virtually at their first contact with the consumer--a guaranteed amount for closing costs since the charges for services in the package would likely result from prearrangement with service providers. But other creditors--such as small institutions that do not make many mortgage loans and might not package services--may need more time to determine the closing costs; they may not always know at first contact which settlement services they will require, which providers they will use, or the prices they will be charged.

Providing information on the interest rate and points presents different timing issues for creditors than providing information on other charges. For interest rate, points, and APR information, there is a tension between providing consumers with firm, accurate information that will not change and providing them with information sufficiently early in the application process so that consumers can shop. The time needed to make firm information available on rate and points could range from an hour or even minutes for creditors that have sufficient information and that rely on automated underwriting, to weeks for creditors that underwrite manually, particularly if they must wait for information from outside parties.

Consumer advocates believe that guaranteed cost information, including guaranteed interest rate and points, is more important for effective shopping than receiving disclosures at the earliest possible time. These advocates express concern that since creditors may use interest rate or points to defray settlement costs, creditors could underestimate other charges and then recoup them later through the rate or points. Moreover, they say it is critical that consumers not have to pay any significant fee before receiving disclosures of guaranteed closing costs and interest rate and points.

Many creditors say offering guaranteed rate and points information is not feasible without full underwriting, which is both costly and time-consuming, and that, therefore, they need to be able to collect a fee before undertaking this work. Some wholesale lenders are further concerned that creditors, including mortgage brokers, will not all be able to adequately underwrite the loans early in the process, and yet would be expected to guarantee rates and points that bind the investors. Other industry representatives counter that many creditors, including mortgage brokers, currently provide firm information on rates and points early in the shopping process based on credit reports--prior to collecting any fee and without any assurance the consumer will commit to getting a loan from the creditor.

The Board and HUD recommend that consumers be given initial cost disclosures, the A-4 Guaranteed-Cost Disclosure Form or A-6 Good Faith Estimate Disclosure Form, as early in the shopping process as possible. While the agencies differ somewhat in their approaches on this issue, advances in technology and competitive market forces will result in consumers' getting better information at or near application.

1. HUD's Recommendation. HUD believes that consumers should be provided initial disclosures under the estimated cost approach as early as possible, as early as technology will permit.

Under a guaranteed cost approach, HUD believes that consumers should be provided guaranteed information about interest rate, points, and other closing costs early enough so that they can shop and make informed choices. HUD also believes that creditors must be able to assure that they have adequate security for their loans. HUD is aware that industry and consumer groups have been working on approaches to assure that creditors have sufficient information to make a guaranteed offer of interest rate, points, and closing costs early in the shopping process. HUD supports these efforts.

One proposal is that the consumer would arrange for the creditor to have access to the consumer's credit report and to review it before requesting a guaranteed shopping price. The creditor would then provide the consumer with a guaranteed interest rate along with points and closing costs based on the credit report and information the consumer provided on the application, including employment information. (The creditor could also arrange for the credit report directly with the consumer's permission.) At this stage the consumer would be charged only for the cost of the credit report.

Since the creditor would provide the guaranteed information on the strength of the credit report and consumer information on the application, the guarantee would likely be subject to appropriate conditions, such as verification of the consumer's income and the value of the property. The guarantee would stand for a reasonable time to permit the consumer to shop. And unless the borrower chose to formally apply and "lock" the interest rate, any subsequent change in interest rate and points (but not closing costs) would be permitted, so long as any change to the consumer's guaranteed rate was solely attributable, and commensurate with, changes in the financial markets.

While some in the industry have expressed concerns about this and other similar approaches, HUD believes that these concerns can be resolved, particularly in the context of a reform proposal that to a significant extent would end § 8 uncertainty. HUD believes technology promises to make earlier disclosures possible for all loans regardless of whether a creditor chooses to estimate closing costs or to guarantee closing costs, interest rate, and points.

HUD recommends that the initial disclosure be provided as early as possible--ideally at first contact with a creditor--assuming the creditor has received sufficient credit information about the consumer. While HUD seeks early disclosures, it recognizes that in some cases (because of the consumer's credit or employment circumstances), there will be a "trade-off" between providing an early disclosure and providing a disclosure that is firm and complete enough to allow the consumer to shop and to protect against any later increase in cost. For such cases, HUD recommends that the timing requirements be flexible enough to allow time to provide guaranteed information. Moreover, in the interest of promoting shopping, consumers should not be required to pay a significant fee to the creditor prior to receiving such information. HUD therefore recommends that initial disclosures, whether it is the Good Faith Estimate or the Guaranteed-Cost disclosure form, be provided before the consumer pays any significant fees.

HUD also recommends that generic information be provided to consumers at first contact with settlement service providers, including creditors and realtors.

2. The Board's Recommendation. Although many creditors can provide consumers with reliable cost disclosures in a relatively short period of time, much of the industry is not yet at the point where it can provide firm or guaranteed closing costs at first contact with the consumer (particularly given the liability that would now attach for exceeding the guarantee or tolerance). Even fewer can fully underwrite a loan within a matter of days. And although consumers need to have firm information, if disclosures come too late they may not be useful. Given this tension between early information and firm information, the Board believes consumers should receive disclosures early in the shopping process rather than after the interest rate and related information can be guaranteed. The Board recommends that the initial cost disclosures (including *reliable* closing costs and *estimated* APR and interest rate) be provided no later than three days after application.

Requiring the initial cost disclosures within three days of application would be consistent with--and improve on--the existing rules. For rate-related and other information about loan terms, all consumers would receive disclosures within three days of application.[67] This would significantly benefit consumers applying for refinance or home-equity loans; they typically now receive the TILA disclosures at closing. For closing cost information, consumers would receive disclosures at the same time as they do now, but the information would be reliable. This timing approach would take into account the operational difficulties faced by small, less automated creditors while recognizing the needs of consumers.

Whether or not disclosures can be provided early, if the consumer has to pay more than a nominal amount to obtain them, the ability to comparison shop will be seriously curtailed for many, if not most, consumers. The issue is whether restricting a creditor's ability to collect fees is the appropriate response. The Board does not support statutory limitation on fees. It believes that creditors can keep fees in a reasonable range as they realize savings from the increased use of technology, and that increased competition in the mortgage lending and settlement services markets also will operate to keep application fees down.

C. Timing Changes to Subsequent Loan Disclosures

RESPA seeks to help consumers avoid unexpected costs at closing by giving them the right to request a copy of their settlement statement one day before closing. This right falls short of its goal, however, because few consumers know about it and because there is no requirement that the settlement statement be complete or accurate prior to closing. Moreover, consumers have no parallel right, in advance of closing, to receive a revised TILA disclosure. If the early TILA disclosures change materially they must be updated, but not until closing.

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[67] To make rules consistent for creditors and to provide all consumers in mortgage loan transactions with rate-related information as well as loan closing costs, the Board further recommends that the HOEPA disclosure (provided for loans with rates and fees above a certain amount) and the reverse mortgage disclosure be provided at this same time.

Several changes could be made. First, the time for providing the settlement statement could be moved from one day to three days before closing.[68] This would allow consumers to have information in time to review it before closing and make any necessary arrangements, or engage in discussions and negotiations with the creditor, if the terms of the transaction are different from what had been disclosed previously. Second, the settlement statement could be provided automatically, rather than on request, and the right to the information could be expanded to include any necessary redisclosure of material terms such as the APR. This would eliminate any concern about consumers not knowing whether they have a right to the information.[69] Third, the quality of the information could be improved by requiring that the disclosures be accurate for all charges.[70]

1. Recommendations. The Board and HUD recommend that, three days prior to closing, creditors be required to redisclose significant changes in the APR or other material disclosures and provide an accurate copy of the RESPA settlement statement.[71] Consumers would receive final cost disclosures prior to closing (rather than, at closing, the current practice) and would then be able to study the disclosures in an unpressured environment. In any instance where there is a material change from the disclosures provided three days before closing, redisclosure at closing would be mandatory. HUD believes that no loan should be closed until the borrower has had three full days to consider the final loan disclosures.

In addition, the Board recommends that for nonpurchase home-secured transactions, a pre-closing right to a refund should substitute for the existing post-closing right to cancel the transaction. See the discussion on rescission in chapter 5.

D. Remedies for Noncompliance

In connection with the recommended timing requirements, the Board and HUD believe that statutory and other penalties are necessary for noncompliance, including the failure to accurately disclose and failure to provide disclosures. These remedies should be appropriately tailored to fit the violation of law.[72]

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[68] The three-day rule would track the current timeframe for providing the HOEPA disclosures.

[69] This rule could also extend to necessary redisclosure of rate-related information.

[70] RESPA currently requires the disclosure of all charges "known to" the person conducting the settlement. 12 U.S.C. 2603(b) (1994).

[71] The Board recommends that the subsequent disclosure rules also apply to the HOEPA disclosure. There is currently no redisclosure requirement in connection with the reverse mortgage disclosure and the Board is not recommending that one be added.

[72] See chapter 7 for HUD's suggestions for improving the remedies under RESPA.

Chapter 5. Right of Rescission

Under TILA consumers have the right to cancel certain home-secured transactions, known as the right of rescission.[73] This chapter discusses the rules on the three-day right of rescission that normally apply and the extended three-year right of rescission that becomes available to consumers when creditors make an error in, or fail to provide, certain disclosures. It then discusses the concerns about the rescission right and recommendations to modify it. The recommendations relate to the discussion in chapter 4 that proposes changes to the timing rules for delivering TILA-RESPA disclosures to consumers.

A. The TILA Rescission Rules

*1. **Three-day Right of Rescission**.* TILA provides that, in certain credit transactions in which the consumer's principal dwelling secures an extension of credit, the consumer has three business days after becoming obligated on the debt to rescind the transaction. This right of rescission was created to allow consumers time to reexamine their credit contracts and cost disclosures and to reconsider whether they want to place an important asset--their home--at risk by offering it as security for the credit. Rescindable transactions include home-secured lines of credit, home-improvement loans and other subordinate lien loans, and many first-lien refinancings.

Not all credit transactions secured by a consumer's principal dwelling are subject to the right of rescission. TILA exempts purchase-money loans. It also exempts transactions in which a consumer refinances a home-secured loan with the original creditor and incurs no additional debt beyond the cost of refinancing the transaction--that is, where no "new money" is advanced. Refinancings by a creditor other than the original creditor, however, are new transactions for purposes of TILA and are subject to the right of rescission.[74]

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[73] The acts of unscrupulous home-improvement contractors provided the impetus for the TILA right of rescission. These contractors would solicit consumers and, through high-pressure sales tactics, offer to make home repairs and arrange financing with a creditor using the consumers' homes as security. Often, the loans were made at exorbitant interest rates, consumers had difficulty paying the creditor, the work was not completed, and by then the home-improvement contractor was no longer in business. In spite of the impetus for the right of rescission, all types of creditors are subject to the right, and all consumers are afforded the opportunity to reconsider certain types of transactions secured by their homes.

[74] The different treatment of refinancings depending on the creditor's designation as the "original" or "new" creditor was based on the consumer's existing relationship with the "original" creditor and the fact that the consumer has already subjected the home to the risk of loss. However, given the significant increase in the assignment of notes and the sale and transfer of servicing rights, the consumer may no longer have a relationship with the "original" creditor. Thus, industry practice has rendered the designations and the distinction between refinancings with the original creditor and a new creditor virtually meaningless. Since consumers often refinance with the current holder of their loan, arguably the basis for the exemption no longer exists or the exemption would be more meaningful if it applied to the current holder or servicer where no new money is advanced.

In a transaction subject to the right of rescission, TILA requires that consumers be given a notice of the right to rescind. The notice must disclose that the creditor has a security interest in the consumer's home, that the consumer may rescind, how the consumer may rescind, the effects of rescission, and the date the rescission period expires.

To rescind a transaction, a consumer must notify the creditor in writing by midnight of the third business day of the latest of three events: (1) consummation of the transaction, (2) delivery of material TILA disclosures, or (3) receipt of the required notice of the right to rescind.[75] The creditor may not disburse any monies (except into an escrow account) and may not provide services or materials until the three-day rescission period has elapsed and the creditor is reasonably satisfied that the consumer has not rescinded. If the consumer rescinds the transaction, the creditor must refund all amounts paid by the consumer (even amounts disbursed to third parties) and terminate its security interest in the consumer's home.

2. ***Waiver of Three-day Right of Rescission***. Under present law, a consumer may waive the three-day rescission period and receive immediate access to loan proceeds if the consumer has a "bona fide personal financial emergency." The emergency must be such that it will occur before the three-day rescission period ends. The consumer must give the creditor a signed and dated waiver statement that describes the emergency, specifically waives the right, and bears the signatures of all consumers entitled to rescind the transaction. The consumer provides the explanation for the bona fide personal financial emergency, but the creditor decides the sufficiency of the emergency. Given the potential liability for failure to comply with the rescission rules, creditors are generally reluctant to accept consumer waivers.

3. ***Three-year Extended Right of Rescission.*** If the required rescission notice or material TILA disclosures are not delivered or if they are inaccurate, the consumer's right to rescind may be extended from three days after becoming obligated on a loan to up to three years.[76] If the consumer rescinds the transaction at any time during the three-year period, the creditor is required to refund all interest and fees paid by the consumer (although the consumer must return any monies or property already delivered to the consumer).

The TILA Amendments of 1995 significantly limited the use of the three-year extended right of rescission. They reduced dramatically the instances in which consumers' right of rescission could extend beyond three days because of minor disclosure errors, by

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[75] Material TILA disclosures consist of the finance charge, the annual percentage rate, the total of payments, the payment schedule, the amount financed, and the disclosures and limitations for HOEPA-covered loans.

[76] Some consumer advocates have argued that state law may extend the rescission remedy beyond three years. In Beach v. Ocwen Fed. Bank, 118 S. Ct. 1408, 140 L.Ed.2d 566 (1998), the U. S. Supreme Court held that TILA's extended right of rescission expires after three years.

creating three separate finance charge tolerances that apply when a consumer seeks to rescind a mortgage loan.[77] The three-year rescission remedy is still available for serious TILA disclosure violations.

B. Concerns with the TILA Right of Rescission

Some creditors and consumers believe that the three-day right of rescission has little utility and should be eliminated or more freely waived. Some consumers are annoyed by the inconvenience (the delay in receiving funds) associated with the three-day right of rescission.[78] Consumers do not often exercise the right.

Creditors believe the penalty associated with the right of rescission--the return of all fees paid to the creditor as well as third parties involved in the transaction--is unduly harsh. Moreover, creditors have complained that some consumers use their three-day right of rescission as leverage to negotiate more favorable terms or to make creditors honor expired commitments to extend credit at a particular rate, rather than to reconsider having put their home at risk.

C. Proposed Changes to the Right of Rescission

The right of rescission is an important consumer protection, and eliminating it raises concern because the consumer's home is the collateral for the debt. Nevertheless, for some transactions, consumers may not need or want the right, for example, when a consumer refinances a home loan merely to obtain a lower interest rate. In such a case, the home is already at risk, and from the consumer's perspective, the refinancing is likely more favorable than the original obligation.

For other transactions the right may be more beneficial. For example, the right of rescission may be important for consumers who decide to consolidate unsecured debt by obtaining a home-secured loan, or those who obtain home-secured credit repair or home-

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[77] The disclosed finance charge is considered accurate if it overstates the finance charge or if it understates it by no more than 1 percent of the total loan amount in refinancings with a new creditor where no new money is advanced and there is no consolidation of existing loans (or 1/2 percent for HOEPA-covered and other rescindable loans). However, once foreclosure is initiated, these rescission tolerances are no longer applicable; the disclosed finance charge is considered inaccurate, and rescission is allowed, if the finance charge is understated by more than $35.

[78] One concern raised over the years is that during the three-day rescission period for a refinanced loan some consumers pay double interest. TILA prohibits certain actions during the rescission period, but it does not prohibit creditors from accruing finance charges. Thus, consumers who are refinancing or consolidating debts are required to wait three days after consummation for disbursement of their funds and may be paying interest on the original as well as on the new obligation.

improvement loans which may be susceptible to higher pricing. Moreover, the three-year extended right of rescission provides a remedy for fraudulent or abusive lending practices (and against the loss of a consumer's home) that does not require the lengthy and costly litigation associated with bringing a fraud or misrepresentation case against an unscrupulous creditor.

As part of the TILA-RESPA reform effort, congressional consideration should be given to revising and improving the rescission rules to address some concerns about the right and at the same time preserve it in appropriate circumstances. A revised scheme for consideration is discussed below.

1. Substituting the Post-closing Right to Rescind with a Pre-closing Right to a Refund for Some Transactions. Chapter 4 discusses changing the time for delivering disclosures to consumers. The changes would require that creditors redisclose significant changes in the APR or other material disclosures and provide an accurate copy of the RESPA settlement statement no later than three days before closing. Also at that time, for rescindable loans, consumers could be given a right to a refund of fees paid (and notice of that right) instead of the right to cancel the transaction (and obtain a refund of fees paid) within the three days after closing. Consumers would have three days to review disclosure information and decide whether or not to complete the home-secured transaction, instead of reviewing loan documentation within the three days after closing and deciding whether or not to rescind the transaction.[79] To ensure the consumer's protection, this pre-closing period could not be waived.

Both creditors and consumers could benefit from this change in the law. Consumers would receive reliable disclosures at a time that reduces the pressure associated with a loan closing and allows for re-evaluation of the transaction. Funding delays would be eliminated. Creditors would not bear the time and expense of completing a transaction--including preparation for closing--only to have the transaction potentially unwind.

2. Rights when Disclosures Provided Prior to Closing are Inaccurate. If a creditor provides a cost disclosure prior to closing, as discussed in chapter 4, that has inaccurate material information, or fails to provide the disclosure, including the notice of the right to a refund, the creditor would have to provide accurate cost disclosures at closing and

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[79] Currently, loans subject to HOEPA have a three day pre-closing period to review the special HOEPA disclosures. Only consumers with loans that currently are subject to the right of rescission would be given the pre-closing right to a refund, or the right could apply more broadly to home-secured loans other than purchase-money loans.

the consumer would then have the rescission right currently in TILA.[80] Errors in the disclosures provided at closing, or failure to provide the disclosures would result in an extended right of rescission for up to three years.

*3. **Waivers.*** Under a revised scheme, the proposed pre-closing three-day right to a refund--to review disclosures and decide whether or not to complete the transaction--could not be waived. Nevertheless, in the circumstances where consumers continue to have a three-day right of rescission (because pre-closing disclosures were inaccurate or were not provided), the Congress should consider allowing consumers to waive that right more freely than under current law. Currently, to waive the right of rescission the consumer must have a bona fide personal financial emergency, which generally creditors are reluctant to accept. But if consumers are given greater flexibility to waive the right of rescission, routine waivers in all cases could lead to abuse by creditors that might pressure consumers into waiving their rights. To address this concern, the act could continue to prohibit preprinted rescission waiver forms.[81]

The greater flexibility to waive the right of rescission should not be extended to HOEPA loans, for which the Congress has determined protections are especially needed. Consumers with HOEPA loans would be entitled to waive their rescission right to meet a bona fide personal financial emergency--the standard currently in the law--such as an impending sale of the consumer's home at foreclosure during the three-day period.

Some consumer advocates have expressed concern that by waiving the three-day right of rescission to receive funds earlier, consumers also waive the extended three-year right of rescission. Advocates view the extended right of rescission as the only true remedy available for saving a consumer's home from foreclosure. Revisions to TILA could expressly provide that if disclosures provided at closing (under the revised timing scheme) contained material errors, or were not provided, consumers would not forfeit their three-year extended right even if they had waived their three-day right. (Such a waiver would have been based on inaccurate disclosures and should therefore be voided.) Creditors might argue that this approach keeps them subject to the possibility of unduly harsh penalties. But the importance

[80] Alternatively, when disclosures are inaccurate or are not provided, an additional delay in closing that the consumer could waive could be required. In HOEPA transactions, if material information in the final disclosures changes before consummation, redisclosure is required, and the closing must be delayed for three additional days. This requirement has proved troublesome for both consumers and creditors.

[81] In September 1994, the Board was directed to study, and submit recommendations to the Congress, on whether consumers would benefit from the ability to waive the right of rescission more freely in connection with loans with new creditors to refinance or consolidate additional debt when no new money is advanced. Based on its own analysis, public comments, and consultations with the Board's Consumer Advisory Council, the Board determined that, on balance, consumers would benefit from being able to more freely waive the right of rescission in limited circumstances. But the Board recommended that routine waivers should not be permitted.

of the right of rescission to consumers in avoiding the loss of their homes seems to outweigh the potential risk to creditors, especially since the reason the consumer would retain the extended right is because of a creditor's noncompliance with TILA by providing inaccurate or no disclosure.

D. Recommendation

The Board recommends that, for transactions currently subject to the right of rescission, consumers be given a right to request a refund of fees during the three-day period before closing. If the right is exercised, all fees paid must be refunded by the creditor. Notice of the right would have to be given no later than three days before closing. This new right would be a substitute for the existing post-closing right of rescission in most instances.

If disclosures were not provided or consumers received inaccurate disclosure of material information before closing, creditors would be required to provide accurate cost disclosures at closing, and consumers would have the three-day right of rescission. Consumers would be able to freely waive the right except for HOEPA loans (where only waivers for a bona fide personal financial emergency could be accepted). The three-year extended right of rescission should be available in instances when inaccurate disclosures were given at closing, or were not provided, even if a consumer waived the three-day right of rescission.

Chapter 6. The Need for Additional Substantive Consumer Protection

Should Additional Substantive Consumer Protections be Added to the Statutes?

Abusive practices continue to exist in some segments of the home-equity lending market, demonstrating the need for additional protections. Previous chapters of this report focus on the benefits of simpler, earlier cost disclosures that will help many consumers comparison shop to avoid the most expensive loans. However, improved disclosures may not aid comparison shopping significantly in underserved markets where there is less competition. In addition, it is unlikely that improved disclosures alone can adequately protect vulnerable consumers from unscrupulous creditors that engage in deceptive and abusive practices.

The Board and HUD believe that substantive protections dealing with predatory lending practices are necessary to ensure that all consumers benefit from reform of TILA and RESPA. The Board and HUD recommend that substantive protections be adopted that will target abusive lending practices without unduly interfering with the flow of credit, creating unnecessary creditor burden, or narrowing consumers' options in legitimate transactions. However, any new rules should be part of a multifaceted approach that also includes nonregulatory strategies, such as increases in counseling and education efforts and voluntary industry action.

This report discusses three primary areas where legislative efforts might be focused:

- Addressing specific abuses or practices through precisely tailored rules (for example, by amendments to HOEPA).

- Enhancing private remedies and public law enforcement.

- Improving the information available to consumers so they can better weigh risks and costs, make more informed decisions, and avoid unwarranted foreclosures.

A. Background and Overview

1. The Agencies' Objectives. The fundamental issue is determining what degree of government involvement is appropriate in regulating home-equity credit markets. Markets operate more efficiently when consumers are well informed; and improved disclosures assist in that process. Additional counseling or education to aid consumers' understanding would also be beneficial. However, by themselves these improvements will not eliminate the problems created by unprincipled creditors or mortgage brokers that use fraud or deception.

Consumers who replace unsecured credit with home-secured loans place their homes at risk in the event of default. In return, they may benefit financially by replacing significant amounts of high-rate, unsecured debt with lower-rate home-secured credit. Even consumers who cannot qualify for the lowest mortgage rates may benefit, and they may obtain a more favorable tax treatment of borrowing costs. The problem arises when consumers are pressured unfairly or deceptively into entering these transactions, later to discover that the promised benefits were illusory.

In considering options for reform, it is essential to recognize that any regulatory scheme involves trade-offs. Government-imposed rules dictating when and on what terms consumers can obtain credit sometimes raise issues of fairness and economic efficiency. Legislative rules tend to be less flexible and to allocate credit less efficiently. Caution should be taken not to enact broad rules that unnecessarily burden the entire home-equity credit industry in an effort to regulate the few unethical or dishonest players. The desirability of a rule that narrows a consumer's options depends on the circumstances or the perspective of the particular consumer. Preserving consumers' ability to choose loan products that meet their particular needs ought to be a significant consideration.

Whatever statutory changes the Congress may enact, there probably will continue to be some creditors and mortgage brokers that will try to take financial advantage of those who are most vulnerable. If undeterred by the existing laws, they may not be deterred by new prohibitions or they may simply devise different schemes. There is no gain from new rules if they are followed only by those creditors and mortgage brokers who have not been causing problems. Accordingly, new rules or remedies should be precisely fashioned to address the specific abusive practices that are of concern. At the same time, the fact that no individual reform can fully eliminate abusive lending should not deter the effort to achieve meaningful progress through incremental improvements.

Legislation should not be the sole focus of the effort to curb abuses. Other ways to deter them should also be considered. A multifaceted approach is likely to be more effective, including stronger government enforcement efforts under the existing laws and educational efforts by the mortgage industry and government. The mortgage industry, working with federal and state regulators, should itself continue to seek practical means to reduce, if not eliminate, abuses in home-equity lending.

2. Protection Afforded by the Home Ownership and Equity Protection Act. While TILA is primarily a disclosure statute, it has always contained substantive consumer protections such as the right to cancel certain home-secured loans. In 1994, the Congress added to TILA's consumer protections by enacting HOEPA, which contains substantive rules aimed at protecting consumers from abusive lending practices.

HOEPA was a legislative response to evidence of abusive practices involving loans to elderly and often unsophisticated homeowners who were encouraged to use the substantial equity in their homes as security for credit. These loans, typically for home repairs or debt consolidation, carried high interest rates and fees and repayment terms the homeowners could not possibly meet. Substantial closing costs and other charges were often added to the loan amount, thereby reducing homeowners' equity and increasing their monthly payment. Frequently, the loans included short-term balloon payments that forced homeowners to refinance the debt. In short, because of the homeowners' equity in the property, the loans were sometimes made without consideration of the borrowers' ability to repay.

The practice of offering high-priced loans to "house-rich but cash-poor" consumers has been referred to as "reverse redlining"--when creditors target low-income communities and elderly homeowners who have traditionally been denied access to mainstream sources of credit. Because competition in these markets is limited, unscrupulous creditors can make loans with interest rates and fees significantly higher than the prevailing market rates. These loans also may contain onerous terms, such as prohibitively high prepayment penalties that discourage refinancing the loan with other creditors on more reasonable terms.

HOEPA seeks to protect these homeowners from loan agreements that are likely to result in default and the loss of their homes, but it does not limit the rates that creditors may charge or prohibit creditors from making high-priced loans. Instead, the act adds a regulatory scheme for high-priced loans that layers new disclosures onto those required in more conventional transactions and prohibits creditors from including certain terms in loan agreements.[82] These changes to TILA were implemented in section 32 of the Board's Regulation Z.[83]

In June 1997, the Board held hearings to assess HOEPA's effectiveness in combatting abusive lending practices. Because compliance with HOEPA did not become mandatory until October 1995, the information available at the June hearings was limited. (See chapter 2 and appendix E.)

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[82] Among the terms that are prohibited are (1) balloon payments in loans with maturities of less than five years, (2) payment schedules that result in negative amortization, (3) higher interest rates upon default, and (4) prepayment penalties in most instances. Creditors are also prohibited from engaging in a pattern or practice of making loans that rely solely on consumers' homes as the source of repayment without considering whether the consumer's income, debt, and employment status would support repayment of the debt.

[83] HOEPA does not apply to home-purchase loans or to open-end lines of credit because the congressional hearings prior to HOEPA's enactment demonstrated little evidence of abusive practices with these types of transactions. Reverse mortgages are also exempt from the HOEPA rules for high-priced loans, but are subject to an alternative disclosure scheme.

3. ***The Current Market for Home-equity Credit.*** Since HOEPA's enactment, the volume of home-equity lending has continued to increase significantly.[84] The capital markets have provided additional funds for home-equity lending (including the subprime lending market) by establishing securitization programs, similar to those that exist for home purchase loans.[85] Some large creditors now securitize nearly all home-equity loans that they originate. Creditors testified at the Board's June 1997 hearings that industrywide, the number of securitized home-equity loans rose from approximately 40 percent of loans originated in 1991 to about 80 percent today.[86]

Some creditors specifically target subprime borrowers--consumers with relatively low incomes, or credit histories that are limited or tarnished. Although these consumers may have difficulty obtaining more traditional financing, creditors in the subprime market will extend credit to them carrying higher interest rates and fees. Because of the higher costs, these subprime loans may be covered by HOEPA, but they do not necessarily involve deceptive or abusive practices. Thus, although HOEPA seeks to regulate abusive lending practices, the act's triggers also bring many legitimate high-priced loans within HOEPA's coverage. Home-equity creditors argue that any new regulatory requirements should focus on specific abuses and not on subprime mortgages in general, because the cost of HOEPA compliance can add regulatory costs to loans that are already high-priced.[87]

Consumer advocates corroborate creditors' statements about the increase in

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[84] It has been estimated that home equity loans outstanding in 1997 totalled $420 billion, compared to $274 billion in 1994. See Glenn B. Canner, Thomas A. Durkin, and Charles A Luckett, *Recent Developments in Home Equity Lending*, 84 Federal Reserve Bulletin 241, 248 (April 1998).

[85] Some creditors point to other factors to explain the rapid rate of expansion in home-equity lending. Specifically, they cite the financial difficulties of the savings and loan industry as the reason for the diminishing availability of consumer loans from traditional banking institutions. As a result, loans made by non-bank creditors became a more significant source of consumer credit. Next, changes in the tax code eliminated consumers' ability to deduct interest payments on consumer loans unless they were home-secured and consumers realized that they could reduce their borrowing costs by replacing existing credit card debt and other unsecured loans with home-secured credit.

[86] Creditors also testified that the potential financial penalties for noncompliance with HOEPA has had a chilling effect on some creditors and investors. In light of subprime creditors' ability to securitize HOEPA loans, it appears that the capital markets as a whole are sufficiently comfortable accepting the potential risk of non-compliance.

[87] Testimony at the Board hearings was mixed on whether the cost of home-equity credit has increased since HOEPA was enacted. Some creditors say that the increase in their compliance cost has driven up the cost of credit for consumers; others say that increased competition and the influx of capital from securitization programs have driven consumer costs down. And some suggest that certain fixed closing costs merely appear high when applied to small loan amounts, compared with similar costs charged for larger home-purchase loans.

competition as more firms enter the subprime lending market.[88] But they do not believe that the increased competition has had the effect of diminishing the problem of "reverse redlining." Consumer advocates contend that creditors' increased profits and interest in this segment of the market suggests that subprime borrowers may be charged disproportionately more than the amounts necessary to cover the higher risk of default.[89]

4. The Continuing Problem of Abusive Lending Practices. Abusive practices in home-equity lending take many forms, but principally fall within two categories. The first category includes the use of blatantly fraudulent or deceptive techniques that may also involve other unlawful acts. These practices occur although they are illegal under existing law and therefore they appear more difficult to curb through legislation. They include: (1) forging signatures or obtaining signatures on blank documents; (2) falsifying loan applicants' income or the appraised value of the property; (3) overcharging consumers with illegitimate fees; (4) selling credit life or disability insurance to consumers who do not qualify for the insurance, or writing policies for amounts that exceed the consumers' indebtedness; (5) fraudulently conveying title in the property to third parties to facilitate the diversion of loan proceeds, and (6) employing bait-and-switch tactics.[90]

In a second category of abuses, various techniques may be used to manipulate a borrower into accepting an exorbitantly-priced or unaffordable loan. The loan documentation might appear on its face to be entirely proper and thus legally enforceable, but the creditor may have engaged in high-pressure sales tactics or misrepresentations that induced consumers to sign documents they did not fully understand for transactions not in their best interest. Creditors sometimes make oral representations about the purported benefits of the transaction that are inconsistent with what is contained in the loan documents. The required disclosures also may be treated in a cursory manner by creditors that discount their significance.

For example, consumers with large credit card balances may seek a home-equity loan to consolidate debts. Consumers enter into these transactions in response to creditors' promises of lower payments or interest rates. But although they may qualify for an

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[88] Their clients often report that they obtained credit in response to creditor solicitations or advertisements rather than initiating a search for a home-equity loan.

[89] Consumer groups also state that the growth and development of the home-equity lending market is being facilitated by the Congress' decision in 1980 to preempt state usury laws for first-mortgage loans. *See* 12 U.S.C. § 1735f-7a (1994). This has also affected the market for subordinate-lien loans or "second mortgages." Some consumers seeking funds for debt consolidation or home repairs may find that the funds are available only if they refinance their existing first mortgage as part of the same transaction. Structured this way, the new loan is exempt from any interest rate caps imposed by state law, and creditors' charges that are calculated as a percentage of the loan amount will be higher.

[90] Consumers Union of the U.S., Inc., Dirty Deeds: Abuses and Fraudulent Practices in California's Home Equity Market (1995).

affordable second mortgage, a predatory lender might pressure them to borrow a larger amount to pay off an existing first mortgage as well, even though the interest rate on the new loan exceeds the interest rate on the existing mortgage. This allows the creditor to assess points and fees based on a larger loan amount.[91]

As a further inducement, creditors may promise that the loan can be refinanced at a lower rate within a short period. But overall, the loan may involve significant transaction costs that do not improve the consumer's financial position. In some cases, the overall transaction may actually result in higher monthly payments because of high closing costs that the consumer must finance. Consumers who subsequently attempt to refinance at a lower interest rate may discover that there is an extreme penalty for prepayment, or that new fees will further reduce equity.

A loan may be structured with low monthly payments that the homeowner can afford, but the payments are too small to fully amortize the principal resulting in a balloon payment at the end of the loan term. When faced with the balloon payment the consumer must ultimately refinance the loan (paying additional fees and closing costs) or face possible default.

In other cases, the monthly payments may not even cover the accrued interest, causing the principal loan balance to increase; this is known as "negative amortization." Although loans covered by HOEPA are precluded from having balloon payments if the loan term is less than five years, and are also prohibited from having payment schedules that result in negative amortization, some abusive loans may fall just below the HOEPA cost triggers. For high-priced loans covered by HOEPA, a predatory lender may schedule balloon payments just beyond the five-year point.

At the Board's June 1997 hearings, consumer advocates reported continued abusive practices in connection with home-equity loans. Consumer groups described many creditor practices that caused consumers' financial status to decline from satisfactory to bad, or from bad to worse. They also expressed concern that, as the total number of subprime loans increases, abusive loans will also increase in absolute numbers.

Mortgage industry representatives acknowledge that abusive practices occur, but they assert that such practices are not widespread in the national mortgage market as a whole and that the vast majority of high-priced loans covered by HOEPA do not end in foreclosure. In their view, providing consumers with more meaningful cost information earlier in the loan

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[91] In addition, any state usury limits would not apply to a first-mortgage loan. State laws restricting other loan terms, such as caps on variable-rate loans may also be preempted for creditors that comply with applicable federal laws and regulations. *See*, e.g., Alternative Mortgage Transaction Parity Act of 1982, 12 U.S.C. § 3801 (1994).

application process, as discussed in this report, will help consumers to compare loans and to avoid transactions with excessive costs. They believe earlier disclosure should also increase market competition, making creditors less likely to offer loans with excessive rates or fees.

Industry representatives believe that the trend toward securitizing subprime mortgages has served to standardize creditor practices and to limit the opportunity for widespread abuse. Creditors that package and securitize their home-equity loans must comply with a series of representations and warranties. These include creditors' representations that they have complied with strict underwriting guidelines concerning the borrower's ability to repay the loan.[92] Creditors also point out that some abusive practices in connection with mortgage loans are not attributable to creditors, but to the actions of independent loan brokers or home improvement contractors who arrange financing but who are not regulated as creditors under TILA.

Consumer advocates have also expressed concern that simplifying TILA's cost disclosures will make it more difficult for consumers to rescind abusive loans. Because of the difficulty, time, and expense involved in proving that a consumer was the victim of unfair or deceptive practices, consumer advocates have frequently relied on TILA disclosure violations to bring legal actions that will allow their clients to retain their homes or obtain other relief. This is possible because creditors who engage in fraud or abusive practices often lack the necessary technical expertise to fully comply with TILA's requirements. In such cases, the TILA violations may provide consumers with a means of rescinding their loans, recovering any out-of-pocket fees, and avoiding foreclosure on their homes. While acknowledging that the use of TILA to stop foreclosures was not the original intent of the legislation, consumer advocates express concern that this option might be unavailable if TILA disclosures are simplified. They contend that any legislation simplifying TILA-RESPA disclosure requirements must, therefore, include new remedies to deal more directly with abusive practices.

B. Addressing Specific Abuses and Practices by Modifying Home Ownership and Equity Protection Act

Both creditors and consumer groups believe that improvements to HOEPA's substantive protections can and should be made, but their reasons differ. Creditors seek statutory clarification and simplification to ease compliance burdens and reduce the risk of inadvertent noncompliance.[93] Consumer advocates believe that the act, though an important first step, provides inadequate protection for the most vulnerable consumers, and they

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[92] It also has been asserted by some that as government sponsored enterprises, Fannie Mae and Freddie Mac, enter the subprime market, they could establish clear industry standards for subprime mortgage lending as they have for conventional mortgage lending.

[93] The Board's interpretative rulemaking authority is limited under HOEPA. 15 U.S.C. § 1604(a) (1994).

recommend some specific changes. Accordingly, industry and consumer representatives have offered various ideas for strengthening HOEPA while seeking to preserve consumers' credit options.

1. Home Ownership and Equity Protection Act Coverage Issues. Some creditors keep their rates and fees just below HOEPA's cost triggers in order to avoid the act's substantive restrictions. Consumer groups believe that because these are subprime loans that carry relatively high rates and fees, consumers still need to be protected from predatory lenders that structure loans with repayment terms that are unaffordable given the consumer's income.

Consumer advocates suggest that the rate and fee triggers should be lowered to bring more loans within HOEPA's coverage. HUD supports lowering HOEPA triggers as part of a comprehensive approach to address abuses in lending. In addition, consumer advocates suggest adopting additional criteria for determining whether a loan is subject to HOEPA. One option would be to establish a HOEPA trigger based on the ratio of a consumer's total monthly debt payments (including the loan payment) to the consumer's monthly gross income. If a home-equity loan caused the consumer's debt-to-income ratio to exceed a specified amount, HOEPA's protections would apply. For instance, HOEPA's restrictions on prepayment penalties would apply even if the creditor charged interest and fees below HOEPA's cost triggers. This could allow some consumers to refinance their loans on more favorable terms and lower their monthly debt without incurring significant penalties.

Currently, HOEPA applies the same set of requirements to all loans that meet the law's cost triggers. Another option would be to consider a regulatory scheme that uses loan cost and possibly the consumer's debt-to-income ratio to divide HOEPA loans into two categories. For example, loans would not be covered by HOEPA if they have APRs and fees *below* an initial trigger amount (the current rule) and if the consumer's debt-to-income ratio is at or below a specified level, for example, 45 percent. Loans that have an APR or fees above the initial HOEPA price trigger (which are currently covered) or loans in which the consumer's debt-to-income ratio is above 45 percent would be subject to HOEPA's existing rules and perhaps some additional restrictions. There would be a third tier for loans with APRs or fees above a second, higher-price HOEPA trigger and loans with higher debt-to-income ratios, for example, exceeding 55 percent. These loans would be subject to additional rules designed to prevent the more abusive practices, including loan flipping.[94]

Creditors have some concerns about a regulatory scheme based on debt-to-income

[94] Consumer groups have suggested, among other things: further restricting balloon payments and prepayment penalties; prohibiting creditors from financing any closing costs and adding them to the loan amount; prohibiting loans with a loan-to-value ratio above 80 percent; prohibiting the use of home-equity loans to pay off unsecured debts; and requiring creditors to use the judicial process to foreclose on a property.

ratios. They express some uncertainty about whether they would be able to determine a consumer's debt-to-income ratio with sufficient accuracy. They note that the accuracy depends in part on information supplied to them by the consumer and that the ratio is subject to change between application and loan closing. Although creditors commonly use these ratios in keeping with their underwriting guidelines, that use does not call for the same level of accuracy that would be required to comply with a statutory trigger. They say that it was concerns of this nature that led the Congress to reject the use of a debt-to-income ratio test when HOEPA was enacted.[95]

2. *Problems with Loan Flipping*. Consumer groups applaud HOEPA's current restrictions on loan terms as an important first step to curb the practice of loan flipping, but note there is ample evidence that the practice continues.

Loan "flipping" or "churning" refers to the frequent refinancing of home-secured loans. It can occur when consumers are unable to make the scheduled payments on their existing loan and are forced to agree to a new loan to avoid default or foreclosure. Some creditors extend credit knowing that the consumers cannot afford the scheduled payments, knowing that the loan will have to be refinanced within a short time. Loan flipping typically provides little economic benefit to the consumer in comparison with its cost, but it provides significant income to the creditor, principally in points and fees charged on the new loan, often coupled with penalties assessed for prepaying the existing loan. Because the costs of the refinancing are usually added to the loan amount, loan flipping typically reduces the homeowner's equity in the property.

Flipping also may occur when a creditor solicits a borrower to refinance a loan by offering additional cash, lower monthly payments, or both. The savings to the consumer may be illusory if lower monthly payments result from a longer amortization period and the total finance charges and APR actually increase.

HOEPA seeks to prevent flipping by prohibiting certain practices and loan terms that may create unaffordable repayment obligations that are likely to require refinancing. For example, HOEPA prohibits home-secured loans that include balloon payments for short-term loans to restrict non-amortizing loans that the consumer cannot afford to repay unless the loan is refinanced. Similarly, the act prohibits using payment schedules that cause the principal loan balance to increase (negative amortization), so that a substantial payment is still due after all scheduled monthly payments are made.

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[95] Traditional purchasers of mortgage loans in the secondary market, such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), generally cap an acceptable debt-to-income ratio at about 38 percent, whereas subprime creditors may accept loan applicants with debt-to-income ratios as high as 60 percent. An earlier version of the HOEPA legislation included a debt-to-income ratio of 60 percent as a trigger.

To curb loan flipping more effectively, consumer advocates believe that additional restrictions for HOEPA loans are necessary that would:

- Prohibit all balloon payments regardless of the loan term.

- Limit the amount of closing costs that can be added to the loan amount to prevent creditors that flip loans from stripping the consumer's equity.

- Reduce consumer costs by limiting the amount of compensation that can be paid to loan brokers.

- Further restrict the use of prepayment penalties to assist consumers who subsequently qualify for lower-cost credit.

At the Board's 1997 HOEPA hearings, two additional rules to curb flipping were suggested: require creditors to prorate the points consumers pay at closing over the life of the loan and require a rebate of any unearned portion if the loan is refinanced by the same creditor, or include the points paid for an existing loan in calculating HOEPA's cost triggers for any refinancing.

a. Balloon Payments. At the Board's HOEPA hearings, differing views were presented about the existing restriction on balloon payments. Most creditors believe a loan with lower monthly payments and a balloon payment can be a useful tool for consumers experiencing cash-flow difficulties or for homeowners who plan to sell the home before the large payment is due. As long as the balloon payment is disclosed, creditors assert that consumers obtaining HOEPA-covered loans should have the same opportunities as other borrowers in structuring their payment streams.

Consumer groups believe balloon payments should be prohibited altogether for HOEPA loans. They question the need for short-term balloon notes with high-priced loans. Consumer advocates say that HOEPA has eliminated some pre-HOEPA practices such as one-year balloon notes, but they criticize the current rule because it allows creditors to make balloon loans that mature in five years. They contend that for HOEPA loans, consumers are just as unlikely to repay or refinance the loan on more affordable terms after five years than they are after two or three years. Alternatively, some consumer advocates suggested allowing balloon payments only when the creditor has agreed in writing to refinance the unpaid balance on comparable or more favorable terms.

On balance, adding restrictions on balloon payments for HOEPA loans seems appropriate considering the repayment abilities of most consumers targeted by HOEPA. Most consumers have to refinance their balloon payment and they incur significant refinancing costs. The benefit of enabling them to avoid refinancing costs generally outweighs the possibility that some consumers will have fewer payment options. Accordingly, extending HOEPA's restrictions on balloon payments beyond the current five year limitation, or prohibiting balloon payments altogether for HOEPA loans (or possibly the highest-priced HOEPA loans), appears to be warranted.

b. Restrictions on Closing Costs. Consumer advocates have testified that homeowners are stripped of their equity when high-priced loans are repeatedly refinanced in conjunction with the charging of high up-front fees that consumers cannot afford to pay at closing and that are, therefore, added to the new loan amount.

Suggestions have been made for removing creditors' incentive to engage in flipping in order to reap up-front profits, for example, by restricting the manner in which the creditors' origination fees and other closing costs are collected in high-priced loans. Rules that narrow consumers' options, however, may not be desirable for everyone. Consumers who experience temporary cash flow difficulties, but who can meet repayment obligations over the long term, may prefer to refinance with lower monthly payments and a balloon note, and may want to draw on the equity in their homes to meet closing costs. Other consumers may prefer, as a matter of choice, to draw on the equity in their homes in order to retain their cash reserves for other obligations that are more difficult to finance. Thus, rules restricting the financing of closing costs may be a necessary protection or an unwarranted limitation, depending on the circumstances and perspective of the particular consumer.

Consumer groups support restrictions on the amount of closing costs that a creditor is permitted to finance as part of the loan amount in HOEPA-covered home-equity loans. Creditors would be limited in their ability to use homeowners' equity as the source for funding excessive up-front fees. Creditors would still have the option of collecting these costs in cash at the closing or building them into higher interest rates.[96] This approach might curb flipping but it might prevent other refinancings as well because some consumers will not have sufficient cash and others may not qualify for monthly payments at a higher interest rate.[97] However, creditors' opportunity to collect up-front fees would be diminished. HUD believes the Congress should regulate the financing of closing costs in HOEPA loans.

3. Prohibiting Loans that Degrade Consumers' Financial Stability. Consumer groups express concern about the manipulation of borrowers into home-equity loans that are

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[96] In the latter case, creditors may impose penalties for prepayment within the first several years to ensure that they recover their transaction costs if loans are pre-paid earlier than expected. If the law were changed to prohibit all prepayment penalties (instead of just prohibiting pre-payment penalties after five years, as the current law does), creditors would not be assured of recovering their costs.

[97] The rule could have mixed consequences. Some consumers might qualify for the higher interest rate but might be deterred by the larger monthly payment; financial pressures might force others into accepting the terms, and they would then face a higher risk of default if their income is adversely affected in the future.

unaffordable. Sometimes creditors anticipate foreclosure or sale of the property and rely on homeowners' equity as the source for repayment of the loan. In other cases, borrowers' income may be misrepresented on the loan application by a loan officer, broker, or home improvement contractor whose chief concern is not repayment ability, but whether there is sufficient equity to allow the up-front charges (including the originator's own fee) to be paid out of the loan proceeds.

Consumer advocates note that, for some consumers, improved disclosures will not prevent these types of abuses effectively. Some consumers, such as elderly homeowners if they are impaired, are particularly vulnerable; so are borrowers who are unsophisticated in their understanding of complex transactions. High-pressure sales tactics and misrepresentations may be used. In short, consumer groups believe that strong legal standards are needed to prevent creditors from making loans that are likely to result in default and foreclosure.

HOEPA prohibits creditors from engaging in a "pattern or practice" of making "hard-equity" mortgage loans; these are loans made in reliance on the value of the consumer's home for repayment even though the creditor is aware that the consumer will be unable to make the scheduled loan payments considering the consumer's income, obligations, and employment status. Consumer advocates report that, despite HOEPA's prohibition, some creditors continue to make loans that consumers cannot afford to repay. In these cases the creditors profit from excessive up-front fees and depend on foreclosure or sale of the property for repayment. Among the clearest cases of abuse are loans made to persons living on fixed incomes where the monthly loan payments approach or even exceed that income; in some cases these borrowers might have qualified for a reverse mortgage that assured them continued possession of their homes for their lifetimes.

To supplement HOEPA's current prohibition against engaging in a pattern or practice of making mortgage loans without regard for the consumer's ability to make the scheduled loan payments, consumer groups support legislation to make the practice illegal in individual cases.[98] Creditors generally agree that no loans should be made with the intent to foreclose or force the sale of the property. On the other hand, some creditors believe that requiring proof of a "pattern or practice" before imposing liability serves a useful purpose and should be retained. They suggest that consumers benefit when underwriting criteria are sufficiently flexible; flexibility allows creditors to consider individual circumstances in judging a consumer's ability to make scheduled loan payments. Creditors say that the

[98] Consumer advocates also favor additional remedies for noncompliance, such as permitting the consumer to rescind a transaction or allowing a court to reform the obligation so that payments are affordable (including voiding amounts loaned to pay fees retained by the creditor).

"pattern or practice" requirement assures that they will not be penalized if, in isolated cases, consumers are approved for loans that do not satisfy traditional underwriting standards.

As a practical matter, because individual consumers cannot easily obtain evidence about other loan transactions, it would be very difficult for them to prove that a creditor has engaged in a "pattern or practice" of making loans without regard to homeowners' income and repayment ability. Thus, the Congress should consider eliminating HOEPA's "pattern or practice" standard, so that individual consumers will have a remedy based solely on their own loans. If the "pattern or practice" requirement is eliminated, creditors should be allowed to accommodate consumers in special circumstances provided that appropriate documentation verifying the circumstances is obtained.

Some consumer groups have also suggested a specific "suitability standard" that would use numerical guidelines to establish presumptions (by statute or regulation) about whether individual loans are affordable. The guidelines would use a consumer's monthly debt-to-income ratio to determine whether a loan is "suitable" for that borrower. Consumers whose loans were found to be unsuitable would be afforded a remedy or creditors might be subject to some form of legislative sanction.[99] For example, in a case where a consumer's debt-to-income ratio is below 50 percent, the loan might be presumed to be suitable, whereas a loan payment that establishes a ratio above 60 percent might be presumed to be unsuitable. In either event, the facts in any individual case could be used to rebut the presumptions. Thus, suitability standards would go well beyond the current framework of HOEPA, which only regulates but does not prohibit the making of any loan.

Mortgage creditors strongly object to the idea of government-imposed "debt ratios" and believe that such standards would be too inflexible. They say that creditors would avoid making loans to consumers with less-than-perfect credit histories if, when a default occurred, a consumer were entitled to contest any foreclosure on the grounds that the loan should not have been made.

4. The Timing and Content of Home Ownership and Equity Protection Act Disclosures. HOEPA's current three-day waiting period--between the delivery of the HOEPA disclosures and loan consummation--seeks to prevent surprises at the closing table due to previously undisclosed costs. Both creditors and consumer advocates believe the rule is unsatisfactory. Consumer groups assert that more time--at least seven to ten days before closing--is needed for consumers to seek advice and perhaps to search for alternative financing. However, their concern would be mitigated if firm cost disclosures are provided

[99] For example, a creditor might lose its security interest in the home, preventing the possibility of foreclosure. Thus, suitability standards would go further than using a consumer's debt-to-income ratio to determine if HOEPA's regulatory requirements apply to the transaction.

for all loans (not just home-purchase loans) within three days of the consumers' loan application, as suggested in Chapter 5.

Creditors criticize the current three-day waiting period before closing as unnecessary, and observe that few consumers cancel the transaction during that period or use the time to negotiate other terms. Creditors believe that TILA's three-day rescission period after closing is sufficient to protect consumers, and that the combined waiting period of six days for HOEPA loans is excessive. Their concern would be alleviated if the Board's recommendations concerning rescission, discussed in Chapter 4, were adopted; creditors that provided accurate cost disclosures for loans three or more days before closing, including any required HOEPA disclosures, would not be required to provide an additional three-day cooling-off period after the closing.

Concerns were also expressed at the Board's June 1997 hearings about the requirement for redisclosure. HOEPA is designed to provide consumers with basic cost information and an opportunity to consider whether to proceed with the transaction. The redisclosure rule protects consumers from creditors' promising one set of terms and arriving at the loan closing with documents reflecting another. Where significant disparity exists between HOEPA disclosures and the cost disclosed at closing, additional time to consider the new terms seems appropriate.

Creditors reported that loan documents are commonly revised because consumers change their minds about how much money they need for personal use or, in debt consolidation loans, when the number or amount of loan payoffs changes. Creditors state that their frustration and consumers' annoyance is exacerbated when such changes require new HOEPA disclosures and a new three-day waiting period before closing. Creditors asked for some flexibility in the redisclosure requirement, so that a new waiting period would not be required when the change benefits the consumer or is de minimis. Consumer advocates acknowledge that a de minimis rule seems reasonable, but many fear that in the legislative process, and over time, the tolerance would increase beyond an acceptable level.

Creditors have offered a variety of standards that they consider to be de minimis. All agree that an increase in the monthly payment of less than one dollar should be within the tolerance, and no redisclosure or additional delay in closing should be required in that situation. Some creditors suggest that a tolerance of 1 or 2 percent of the amount disclosed be permitted before a new waiting period is imposed. Larger tolerances are more problematic. For example, a 10 percent tolerance would allow an increase in the monthly payment amount from $350 to $385. This may be de minimis to some consumers but not others.

5. *Rules for Sales of Credit Insurance*. Consumer groups continue to express concern about the sale of credit insurance (life, disability, and unemployment). If the

insurance is optional, creditors need not include charges for credit insurance as part of the disclosed finance charge or the APR, provided that its optional nature and the premium amount are disclosed as required by the regulation. Currently, TILA does not contain any other rules or limitations regarding the sale of credit insurance.

Consumer advocates say that because credit insurance is highly profitable for creditors, consumers are frequently subjected to high-pressure sales tactics at the loan closing, with little opportunity to comparison shop or reflect on the decision. They are especially concerned that consumers targeted by HOEPA are sometimes charged exorbitant premiums that add significantly to the total cost of the transaction. Moreover, because credit insurance costs are not included in calculating whether a loan is covered by HOEPA, a creditor can keep the interest rate and closing fees just below HOEPA's triggers for coverage and still achieve a high return by inflating the cost of credit insurance sold with the loan. The Congress may wish to consider whether it would be appropriate to include these credit insurance premiums in HOEPA's fees-based trigger.

Consumer groups believe that more competitive pricing of credit insurance could be achieved if the insurance were sold after the loan closing. Creditors, on the other hand, believe that consumers should be able to benefit from the convenience of one-stop shopping as long as they receive the required disclosures.

Consumer groups also express concern about the practice of collecting the insurance premiums for the entire loan term in advance. Moreover, these premiums are usually added to the loan amount, which increases the total finance charges paid by the consumer. If the loan is later refinanced or is paid off before maturity, the entire premium will not have been earned, but consumers may not know to seek a rebate, or may not know how to do so. Consumer groups (and many creditor groups) support legislation that would require creditors to collect credit insurance premiums periodically with the consumer's regular mortgage payment for HOEPA loans.

The regulation of insurance, including the allowable premium rates, has historically been a matter for state law. It may be feasible, however, to prevent some abusive practices by regulating the method for collecting credit insurance premiums in connection with HOEPA loans. For such loans, the Congress should consider prohibiting the advance collection of premiums, so that consumers pay periodically--and only for the time the loan is actually outstanding, so that termination of the loan automatically cancels both the coverage and any liability for future payments. If this is done, consumers' need to finance the premiums and add the cost of insurance to the loan amount would be eliminated.

The Congress should also consider whether new legislation is needed to guarantee consumers' right to cancel credit insurance coverage during the life of the loan, or whether adequate protection exists under the state insurance laws. With such a right, consumers pressured into purchasing policies at closing that are not affordable (or not competitively priced) could cancel them and thus lower their monthly payments.[100] In this context it also would be appropriate to consider the need for rules requiring written notice of any rights consumers may have to cancel the coverage and of the steps to follow to exercise those rights.

C. Ensuring Adequate Private Remedies and Public Law Enforcement

Creditors that engage in abusive practices are unlikely to be deterred by additional rules and prohibitions alone. The effectiveness of the law in dealing with abusive practices also depends on adequate enforcement by government agencies and by consumers. The role of the mortgage lending industry and the possibility of self-regulatory action is also important.

1. Enhancing Government Enforcement Efforts. Abusive mortgage loans are not generally a problem among financial institutions that are subject to regular examination by federal and state banking agencies. Abuses occur mainly with mortgage creditors and brokers that are not subject to direct supervision. For most of these entities, enforcement authority under TILA (and other federal consumer protection laws) rests with the Federal Trade Commission. In addition, TILA expressly authorizes state attorneys general to enforce the substantive rules added by HOEPA.[101]

To enhance law enforcement efforts, the number of abusive lending cases investigated and prosecuted should be increased. Supplementing the data available to law enforcement agencies about the practices of non-bank creditors that make subprime loans would be an important first step. In the absence of the type of direct oversight performed by bank examiners, equipping law enforcement agencies with more detailed information would enable them to focus enforcement efforts in a more efficient and effective manner.

One way to do this is to establish a means for monitoring the lending activities of unsupervised creditors that regularly make loans with the greatest potential for abuse. It

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[100] Consumer advocates also report that consumers are sometimes sold unnecessary insurance without their knowing it. For example, a home-secured loan for $50,000 with a 15-year term may require monthly payments of $600, for a total of $108,000 over the life of the loan. Consumer advocates report that some policies and premiums are based on coverage for $108,000, even though the consumer is only liable for the unpaid balance of the $50,000 loan amount. In other cases, they report that creditors falsify insurance applications in order to collect policy premiums even though the consumer may not qualify for the coverage. Although such fraud may be difficult to address through new rules, prohibiting the advance collection of premiums could lessen the economic incentive for creditors, and could make it easier for consumers to cancel the insurance when the abuses are uncovered.

[101] States also enforce their own consumer protection statutes and prosecute cases involving fraud, or may use their licensing authority as a basis for investigating creditor practices.

might entail requiring these creditors to track certain types of loans in order to preserve or record data regarding these transactions. The data could be made available to law enforcement agencies conducting an investigation, or in some instances reported to government authorities on an aggregate basis.[102] The FTC could assist in identifying the particular types of information that would strengthen that agency's investigative efforts.

Additional burdens on broad segments of the mortgage lending industry are not warranted and would only add to the cost of credit. The focus should be on collecting data from unsupervised creditors that offer loans more likely than not to involve abusive practices. For example, creditors that make more than a certain number or dollar-volume of HOEPA loans might be required to keep records showing which transactions involved customers who refinanced within short periods, or which loans were extended to consumers with very high debt-to-income ratios. Requiring these creditors to keep records about loan prices and broker compensation might also enable investigating agencies to identify and target individual cases that deviate most significantly from the prevailing market rates for subprime mortgages.

The ultimate goal is to assist law enforcement agencies in gathering information to identify those creditors or brokers that routinely engage in transactions involving fraud or other illegal practices. A nationwide database covering individuals in the mortgage industry who have been subject to enforcement actions or had their licenses revoked by state regulators might also be created. Concerns for consumer privacy should be addressed, by ensuring that any loan information reported by creditors contains only the minimum amount of personally identifiable information necessary and is available only to the appropriate law enforcement authorities, as is the case with bank examination data gathered by supervisory agencies. HUD supports the development of new recordkeeping and reporting requirements for certain creditors engaged in making HOEPA loans.

2. Additional Consumer Remedies for Unfair or Deceptive Practices. Consumer advocates favor enactment of a broad federal statute applicable to home-secured loans, prohibiting unfair or deceptive acts and practices (referred to as a "UDAP" statute). UDAP statutes that have already been enacted into state law allow consumers to seek redress through private lawsuits if they can show that a particular business practice or transaction was unfair, deceptive, or unconscionable.[103] To obtain relief under a state UDAP statute, consumers typically demonstrate the harmful effects of the transaction; they do not have to prove any

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[102] In this way, covered creditors would operate under increased scrutiny, or otherwise face penalties for failing to comply with the new data collection requirements.

[103] All fifty states and the District of Columbia have enacted at least one such statute, directed at preventing consumer deception and abuse. *See* National Consumer Law Ctr., Unfair and Deceptive Acts and Practices (4th ed. 1997). Many state UDAP statutes cover practices in "trade or commerce" or the "sale of goods and services," but the courts have interpreted them to apply to credit transactions generally, including mortgage transactions. In some states, however, the law does not apply to home-secured loans.

specific intent on the part of the creditor to deceive or defraud the consumer. Proving a violation of a UDAP statue thus would be easier than proving a traditional fraud claim.

Section 5(a) of the Federal Trade Commission Act currently allows the FTC to take legal action against deceptive acts and practices in connection with mortgage loans.[104] It does not, however, give consumers a private right of action. Consumer advocates seek an individual remedy because enforcement actions brought under the FTC Act usually target creditors only after evidence has been collected demonstrating that a pattern or practice of wrongdoing exists. They argue that enacting a federal statute would provide uniform coverage in all states and could declare certain practices unlawful per se, or could define circumstances that create a rebuttable presumption that a transaction was unfair or deceptive. For example, fraudulent practices--such as obtaining signatures on blank documents, backdating documents, or falsifying applicants' income--could be specified in a federal UDAP statute as unlawful practices. A home-secured loan made to a consumer with a debt-to-income ratio exceeding a specified percentage might raise a presumption, subject to rebuttal, that the creditor acted unconscionably by making a loan the consumer could not afford to repay. Consumer representatives also have suggested that where HOEPA already prohibits a particular loan term, a UDAP statute should specify that it is an unfair trade practice for the creditor to attempt to enforce that term.[105]

Creditors are concerned that a federal UDAP statute creating a private right of action would allow lawyers representing consumers with individual complaints to transform those claims into costly class action litigation. There are also questions about the effect that a federal UDAP statute would have on similar state laws. To the extent such laws have overlapping coverage, the legislation might specify whether it intends for consumers to have concurrent remedies or to limit consumers by requiring them to choose between the federal and state remedies. Allowing claims to be resolved in federal court may be unnecessary if there is adequate protection for borrowers under the applicable state law. Accordingly, if a federal UDAP statute is adopted for home-equity loans, the Congress may wish to consider whether it is appropriate to require consumers to utilize their state law remedies where that law is at least as protective of the consumer's rights as the federal statute. HUD believes that the Congress should consider the enactment of such a standard.

3. ***Ensuring Consumer Rights in Foreclosures***. Consumers who have been victims of abusive practices must be provided adequate opportunity to assert their rights in order to avoid unwarranted foreclosures. For the most part, the procedures that a creditor

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[104] 15 U.S.C. § 45(a) (1994).

[105] Consumer advocates also suggest that a creditor's violation of UDAP standards in connection with the making or collecting of a mortgage loan should be a defense to any foreclosure. To the extent that the consumer was liable for the debt, the creditor would lose its security interest in the home and become an unsecured creditor.

must follow for foreclosure are governed by state law, local practice, and the terms of the relevant contract documents. This includes the amount or type of notice that consumers are entitled to receive about an impending foreclosure. Some states require creditors to provide actual notice to the consumer of the foreclosure, but in other states notice by publication is deemed sufficient. In some states a judicial process is followed; the creditor must file a lawsuit and obtain a judgment in order to obtain permission to sell the property. Other states allow the use of a nonjudicial process, where the creditor merely notifies the borrower that the home will be advertised and sold, thereby placing the burden on the homeowner to take legal action to prevent the sale if possible.

Some states afford consumers the right to "cure" a delinquency or default and avoid foreclosure by bringing the obligation current.[106] Even after the time to cure the delinquency has passed, consumers generally have the right to "redeem" the property prior to the foreclosure sale by paying off the full amount of the mortgage plus any fees and expenses related to foreclosure. This is sometimes possible through a refinancing or private sale of the property. A few states even allow redemption of the property after a sale.

Consumer advocates believe that existing state laws do not adequately protect consumers from abusive practices in connection with foreclosures. They support legislation that would grant substantive rights to consumers when their mortgage loans are in default. Specifically, they believe that consumers should have the right to cure their delinquency or default in all cases. Consumer advocates also suggest that a creditor should have some legal duty to agree to a consumer's reasonable request for a modification of the loan terms before being permitted to foreclose.[107]

Consumer groups assert that creditors should be required in all cases to provide consumers with actual written notice of an impending foreclosure. Consumer groups are concerned that even when consumers do receive a notice of foreclosure, they may not get adequate information about the legal options that are available to them under the applicable laws. They state that when some consumers try to exercise their rights, they are unable to obtain accurate, timely information about the amounts they must pay to avoid foreclosure. Accordingly, consumer groups have proposed that consumers be guaranteed the right to terminate any foreclosure proceeding by tendering the amount specified in the creditor's advance notice of foreclosure, even though the creditor may still be able to collect any additional amounts that are due.

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[106] A right to cure the default may be subject to limits on how many times or how often the consumer may exercise the right.

[107] This might be similar to the requirement for creditors to employ foreclosure prevention and loss mitigation strategies for loans insured by HUD.

Some home-equity creditors have voiced support for legislation to provide additional protection for consumers in foreclosure. These creditors propose that consumers be guaranteed the right to receive a notice at least 30 days before foreclosure commences that would explain the foreclosure process. The notice would specify consumers' substantive rights and legal options and include information about the availability of credit counseling. Their proposal would also require creditors to obtain a full appraisal of the property prior to a foreclosure sale in order to ascertain the extent of the homeowner's equity. The purpose of the appraisal would be to determine if the consumer's equity is 20 percent or more of the appraised value; if so, foreclosure would be delayed to allow the consumer to sell the property.

Consumer representatives also believe that allowing foreclosure only by judicial process is important for protecting consumers' interests in the property. They assert that this is particularly important for borrowers who are victimized by unscrupulous home improvement contractors that arrange home-secured financing for the repairs. In these cases, a mortgage may be recorded on a consumer's home even though the home improvements are never completed or have latent material defects. In states where foreclosures do not require judicial process, if a consumer refuses to make payments and is in default, the creditor can commence foreclosure proceedings and shift the burden and expense to the consumer of initiating a legal action in order to assert the contractor's breach as a defense to the foreclosure. Most borrowers are unaware, however, that in such circumstances they may have a valid defense for nonpayment under Federal Trade Commission rules.[108]

Consumer advocates argue that federal law should prohibit nonjudicial foreclosure in home improvement loans. Creditors oppose such a sweeping remedy, but have suggested that additional safeguards are possible, including a requirement for mandatory third-party completion certificates prior to disbursement of funds, and creation of some form of borrower claim process, that would necessitate an independent evaluation and determination of a borrower's claim concerning a contractor's nonperformance before foreclosure could commence.

The Board and HUD support the adoption of certain minimum standards for the notice creditors must provide consumers prior to a home foreclosure. The goal would be to establish procedures that avoid unwarranted foreclosures by maximizing consumers' opportunities to cure a delinquency or arrange other financing. These procedures are especially important where a consumer who is overburdened by an abusive loan can qualify for financing on less onerous terms. The legislation might state that prior to any foreclosure sale, consumers must have first received, in a written notice: (1) an explanation of whatever substantive rights they have under applicable state law to cure the delinquency or redeem the property, and information about how they may do so, including the amounts that must be

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[108] 16 C.F.R. § 433 (1997).

paid; (2) an explanation of how the foreclosure will proceed if they do not exercise those rights; (3) an explanation of other rights they may have under any applicable federal mortgage program, such as an FHA or VA program;[109] and (4) information about the availability of third-party credit counseling. In addition, HUD supports new foreclosure prevention strategies, including, as appropriate, pre-foreclosure counseling, new federal rights for borrowers to cure delinquent loans and the right to recover remaining equity through private sale prior to foreclosure.

4. Regulating Creditors' Use of Mandatory Arbitration. Some creditors have incorporated arbitration clauses in their credit agreements as a response to individual and class action lawsuits challenging creditors' practices. Arbitration clauses require consumers to forego judicial remedies and allow a neutral third party to resolve any dispute arising from the transaction. Consumer representatives have expressed concern about this trend, because the clauses typically mandate arbitration at either party's option. They argue that creditors' use of compulsory arbitration clauses negates consumers' ability to enforce their rights under TILA and other consumer protection statutes.

There are material differences between the way lawsuits and arbitrations are conducted. Most notably, arbitrations do not involve a jury and consumers' ability to gather evidence through pretrial discovery is much more limited. Class actions and punitive damage awards usually are not permitted in arbitrations. Consumer advocates argue that these differences make arbitrations more likely to favor creditors.[110] Accordingly, they support legislation to prohibit the use of compulsory arbitration clauses. Creditors assert that these differences are a strong deterrent to the filing of frivolous claims, which they note must sometimes be settled to avoid costly and time-consuming litigation.

Another option would be to enact certain consumer safeguards. For example, creditors might be required to provide consumers with an early disclosure if a mandatory arbitration clause will be used, so that consumers are informed when they are comparison shopping. At the loan closing, creditors that use mandatory arbitration clauses might be required to have consumers sign a separate acknowledgment rather than having arbitration clauses contained within other complex legal documents that consumers may overlook. This

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[109] Mortgage loans insured by HUD, the Federal Housing Administration (FHA) and the Veterans' Administration (VA) give borrowers certain rights that may not necessarily apply to conventional loans. For example, with FHA loans, creditors must notify a consumer within two months of a delinquency and make reasonable efforts to interview the consumer before the loan becomes three months in arrears. Foreclosures are governed by certain rules, such as requiring creditors to accept partial payments or prohibiting foreclosures where the delinquency involves only an escrow account. Creditors are also expected to consider whether the specific circumstances qualify for one of the FHA's foreclosure prevention strategies or loss mitigation tools, such as a forbearance agreement, loan modification, or a pre-foreclosure sale.

[110] *See generally*, Mark E. Budnitz, *Arbitration of Disputes Between Consumers and Financial Institutions: A Serious Threat to Consumer Protection*, 10 Ohio St.J. on Disp. Resol. 267 (1995).

would be similar to the separate disclosures for credit insurance sales currently required under TILA. There might also be requirements as to the form and content of creditors' disclosures to ensure that a consumer's agreement to enter into a loan with a mandatory arbitration clause is an informed and meaningful decision. This might include information about the differences between arbitration and a lawsuit, so that consumers are aware of the consequences of waiving their rights to use the judicial process.

5. Voluntary Industry Self-Regulation. Consumer protection might also be enhanced by industry self-regulation. The vast majority of mortgage creditors and brokers do not engage in abusive lending. The creation of a voluntary, self-regulatory organization that would offer membership to any creditor or broker that agrees to abide by established ethical standards and rules of conduct would undoubtedly benefit both consumers and legitimate creditors. Creditors that elect to become members and follow these rules would have the ability to use their membership as a marketing tool to gain competitive advantage. Those creditors that do not satisfy membership requirements would risk additional scrutiny from law enforcement agencies, the media, and others.

The success of this effort would depend on the commitment of the organization and its members to informing and educating consumers about its significance. This could include warnings about the need to be wary of firms or individuals that are unwilling to abide by the type of rules adopted by the organization. In addition, such an organization might require its members to provide consumers, by contract, with the option of filing and settling any grievances before a quasi-judicial body established by the organization. This might be particularly useful for consumers needing to resolve minor disputes.

D. Improving the Information Available to Consumers Through Counseling

Consumers who obtain pre-transaction counseling may be less likely to enter into mortgage loans that are not viable in the long run based on their economic circumstances and this may avoid some unwarranted foreclosures. Currently, pre-loan counseling is required under federal law before certain extensions of credit are made, such as reverse mortgages guaranteed by HUD under its Home Equity Conversion Mortgage program, because these transactions are complicated and riskier than conventional mortgages. In other situations, such as default on an FHA-insured loan, consumers are merely provided with information on the availability of HUD-approved counselors, but they are not required to consult one; the consumer ultimately decides whether such counseling is needed. Either approach could be expanded and coupled with consumer education.[111] To be effective, however, there must be

[111] Currently, HUD helps provide funding and training for a nationwide network of independent counseling agencies that provide consumers with information on a variety of topics. For example, under HUD's reverse mortgage loan program, consumers must complete a counseling session which includes information on topics such as the financial implications of entering into a reverse mortgage, possible tax implications, and the availability of other financing methods.

adequate resources dedicated to this purpose, to expand and improve on the existing base of housing counselors.

Good faith efforts to prevent foreclosures are in the best interests of both creditors and consumers. HUD uses counseling as a technique for curing delinquencies on mortgages insured by HUD or the FHA. HUD expects creditors for insured loans to consider the circumstances of each case and execute a plan that promotes foreclosure alternatives and mitigates the potential financial loss that is likely to result. Foreclosure alternatives include the use of forbearance agreements, loan modifications, pre-foreclosure sales, or conveyance of a deed in lieu of foreclosure. HUD requires creditors on insured mortgages to refer homeowners to a qualified, HUD-approved, housing counseling agency early in the default period to clarify the various alternatives available to homeowners and to reduce delays in obtaining assistance. Based on its experience in this area HUD continues to support default counseling.

Consumer representatives support an expanded role for homeowner counseling. Some have proposed that creditors make pre-loan counseling by third-parties available at no cost to consumers, as a means to keep consumers from entering into abusive or problematic loans. They also support making counseling more widely available to homeowners who are in default, even when the loan is not federally insured. As industry representatives note, however, any requirement that counseling be provided to consumers raises the fundamental issue about how the additional costs would be funded.

The initial focus of reform should center on increasing consumer counseling in situations that pose the highest risk to consumers. Homebuyers have varying degrees of experience. Although first-time homebuyers have a greater need for counseling, the need for routine pre-loan counseling for all first-time homebuyers has not been demonstrated and such wide-scale efforts are not likely to be cost effective.

As a general matter, whether to seek pre-loan counseling in routine cases could be left to the discretion of the consumer. There are particular types of loans, however, that are inherently complex or risky. In such cases, the benefits of pre-loan counseling might outweigh any additional costs, which might be reflected in the price of the loan product. Another approach could be adopted requiring counseling before a consumer obtains a HOEPA loan. Yet another approach might be to require counseling before a consumer refinances any loan that was obtained within the previous twelve months, or where the consumer's debt-to-income ratio exceeds a specified level. A more limited approach would be to provide notice about the availability of counseling and how to locate these services before consumers enter into transactions such as HOEPA loans or first-time home purchases.

HUD supports the approach of requiring pre-transaction counseling for HOEPA borrowers, where appropriate.

In addition, greater effort should be made to ensure that consumers who are delinquent or in default on their mortgage loans are adequately informed about counseling resources that may be available to them. This might prevent some unwarranted foreclosures. For mortgages insured by HUD this information is already provided, and HUD-approved housing counselors are available to assist these consumers. Creditors are required to notify consumers about the availability of counseling within a fixed period after the consumer's default and before foreclosure.

E. Recommendation

The Board and HUD recommend that substantive protections be adopted that will target abusive lending practices without unduly interfering with the flow of credit, creating unnecessary creditor burden, or narrowing consumers' options in legitimate transactions. These protections should be included as part of any legislation enacted to simplify and reform TILA and RESPA to ensure that all homeowners benefit from the statutory reform. The report discusses three primary areas where legislative efforts might be focused: addressing specific abusive lending practices; enhancing private remedies and public law enforcement, and; improving the information available to consumers. Any new rules should be part of a multifaceted approach that also includes nonregulatory strategies, such as increases in counseling and education efforts and voluntary industry action.

The Board and HUD specifically recommend:

- Extending HOEPA's restrictions on balloon payments beyond the current limitations or prohibiting them altogether for HOEPA loans (or possibly the highest-priced HOEPA loans);

- Prohibiting the advance collection of lump-sum credit insurance premiums for HOEPA loans, so that consumers may pay premiums periodically with their regular mortgage payments and termination of the loan automatically cancels both the coverage and any liability for future payments; and

- Requiring certain minimum standards for the notice creditors must provide in home foreclosures, including a written notice explaining consumers' legal rights and how they may avoid foreclosure, the process that will be followed if they do not exercise those rights, and information about the availability of third-party credit counseling.

In addition, HUD recommends:

- Lowering HOEPA thresholds combined with prohibitions against loan flipping and other specific abusive practices including such measures as regulating the financing of closing costs, requiring creditors to take into account the consumer's capacity to repay, expanding the current restrictions on prepayment penalties, and providing new protections for home improvement borrowers claiming contractor nonperformance or malfeasance;

- Adopting new foreclosure prevention strategies that, where appropriate, include pre-foreclosure counseling and establish new federal rights for consumers to cure delinquent loans and recover remaining equity through a private sale prior to foreclosure;

- Requiring pre-transaction counseling, where appropriate, for vulnerable HOEPA borrowers;

- Imposing information collection and reporting requirements on certain creditors that make loans covered by HOEPA; and

- That the Congress consider establishing a federal "unfair and deceptive acts and practices" standard to provide a private remedy for transactions that are unfair or unconscionable.

Chapter 7. Additional Reform Issues

This chapter first discusses the need for consumer education in order for consumers to fully benefit from TILA and RESPA reform. The chapter then discusses the agencies' recommendations for harmonizing RESPA's and TILA's coverage of transactions and parties. Finally, it addresses remedies under RESPA including several recommendations for enhancements.

Consumer Education

Mortgage loans are inherently complicated, and the process has become even more so as the variety of available loan products has multiplied. Informed consumers are likely to make better decisions. However, because most consumers are not likely to need or shop for a mortgage more than a few times during their lives, they have limited opportunities to master the technical details of these transactions. Consequently, it is important to provide educational materials at the time they will be most useful, when consumers are directly focused on purchasing or refinancing their homes.

Increased efforts by industry and community groups to educate consumers could have a significant impact. New educational materials or other tools, including videotapes and computer programs, could be developed and widely distributed with the aid of the electronic mass media. This might be undertaken by the mortgage industry in conjunction with consumer and community organizations. Distributing written materials at the point of service may continue to be the most effective means for reaching some consumers, particularly lower-income individuals who in the past have been targeted for abusive loans.

The use of home computers to access the Internet and communicate with financial service providers has already changed the way many consumers obtain information and shop for mortgages. As personal computers become even more affordable and more common in homes, schools, and public libraries, more consumers will obtain information in this manner. The innovative use of technology to reach consumers should also be explored. For example, electronic kiosks at creditors' retail locations or other public places might bring information resources to those who do not have similar private access. Also, electronic information might be provided to some consumers through third parties, such as credit counselors or civic organizations.

*1. **Educating Consumers about Cost Disclosures.*** A commitment to educating consumers about any new disclosure scheme is vital to the success of the reform effort. Consumers will not fully benefit from TILA and RESPA reform and simplified, earlier cost disclosures unless they understand key information presented in the disclosures. In particular, consumers must understand the uses of the APR and the two disclosure approaches--guaranteed and estimated settlement costs--for purposes of shopping and negotiating loan terms.

For example, RESPA currently requires HUD to prepare and distribute a Special Information Booklet to help homebuyers understand the nature and costs of real estate settlement services. The booklet could be revised to incorporate information about the TILA cost disclosures as well, including a worksheet that consumers could complete to compare loans as they shop. Consumers could calculate the cost of the loans for different durations, or evaluate the effect of points, to determine which loan is best for them considering individual factors such as available cash or their anticipated length of stay in the home. Anecdotal evidence indicates that consumers find the Special Information Booklet informative; if revised, it must remain brief and user-friendly to be effective.

HUD's Special Information Booklets must be provided to consumers within three days after loan application for home purchase transactions.[112] The Special Information Booklet could be required to be provided at the time of application instead of within three days.[113] If this is done, the timing would be consistent with the current requirement under TILA that booklets describing adjustable rate mortgage loans and open-end home-secured lines of credit be given at application. This would simplify compliance for creditors by having the same timeframe for all three booklets and would provide educational material to consumers earlier. HUD's booklet for home purchasers could also be offered or given to consumers even before a loan application, such as when the consumer first contacts a creditor or establishes a contractual relationship with a realtor, or other settlement service provider.

2. Education to Avoid Abusive Loans. Education is also important to deter abusive loan practices. Consumers might be better informed and possibly avoid some abusive loans if comparison shopping were made easier. Simplifying and improving TILA disclosures will help, but educating consumers about home-equity loans in particular is also critical. Educational materials should include information about consumers' rights under the laws' substantive protections.

Consumers who obtain information from a variety of sources, either by comparison shopping or by consulting public information resources or counselors, are less likely to become victims of abuse. Consideration should be given to how to increase the public's awareness of this fact, and how to facilitate consumers' ability to gather relevant information. HUD's Special Information Booklet for home purchase loans can also serve as

[112] The Special Information Booklet, which is entitled "Buying Your Home: Settlement Costs and Helpful Information," is also available through the Internet.

[113] As a practical matter, for loan applications taken face-to-face, this is already a common practice. For applications taken electronically or by mail or telephone, they may be mailed to the consumer within three days after application. They could be sent even sooner, but there would still be some delay before receipt.

the model for a similar publication that would be given to all applicants for nonpurchase loans. Information booklets on home-equity loans could inform consumers about common creditor abuses and could explain the advantages of reverse mortgages for some elderly consumers with limited incomes.[114] Consumers could also be educated about the impact of frequent refinancings on consumers' borrowing costs and how the repeated payment of up-front loan fees may increase consumers' total costs even if their monthly payments decline.

B. Harmonizing Coverage under TILA and RESPA

TILA and RESPA both cover consumer mortgage credit, but they differ in the types of transactions and parties covered. TILA's mortgage lending requirements apply to loans made by creditors that "regularly" (more than five times a year) extend consumer credit secured by a "dwelling," whether or not it is attached to real property. RESPA applies to all "federally related mortgage loans," defined generally as transactions secured by residential real property on which a structure is or will be located. In addition to requiring disclosures of specific loan information, RESPA also regulates certain payments and arrangements involving settlement service providers (realtors, title companies, and creditors).

Because of the inconsistencies in coverage, consumers obtaining mortgage credit do not always receive both TILA and RESPA disclosures in a given transaction. For example, a consumer purchasing a manufactured home that will be placed on rented land would receive a TILA disclosure but no RESPA disclosures. And yet, the disclosures seem helpful to all consumers seeking home-secured credit. For creditors, the inconsistencies in coverage add to the complexity and burden of the regulatory structure. Therefore, the agencies recommend that the Congress adopt a common coverage standard under both statutes for mortgage transactions.[115]

1. Mortgage Transactions Covered. TILA's mortgage lending requirements apply to transactions secured by a "dwelling," defined as a residential structure that contains one to four family housing units. The structure need not be attached to real estate. RESPA generally covers any loan secured by real property on which a residential structure is or will be located using the proceeds from the loan. RESPA disclosures are required for credit

[114] Similarly, a booklet about refinancings could help consumers understand the costs involved in such transactions and aid them in determining the relative value of a decreased interest rates and smaller monthly payments compared with pre-paid refinancing costs or prepayment penalties. The Board, in consultation with other banking agencies and industry groups, publishes booklets on home refinancing ("Consumer's Guide to Mortgage Refinancing") and home-equity lines of credit ("When Your Home is on the Line"); only the latter is required to be provided by creditors.

[115] A minimal approach could harmonize TILA and RESPA disclosures by providing a coordinated disclosure where coverage currently overlaps. However, the acts' definitions are complicated and determining where coverage overlaps can be difficult. Amending the statutes to provide for consistency in the credit transactions covered and the parties responsible for providing disclosures seems the better approach.

secured by liens on residential real property (including principal dwellings, vacation homes and time-shares), but not for credit secured by residences unattached to real estate, such as mobile homes that are placed on rented land.[116]

Uniform coverage would be most beneficial if both TILA and RESPA covered loans secured by a "dwelling." This test would result in some additional burden for some creditors. But consumers seeking some home-secured credit unattached to real estate would receive RESPA disclosures that they currently do not receive. TILA's distinction between principal dwelling and other residences could be maintained for rescission or for other special protections that apply when the consumer's primary home is at risk. Having a single set of disclosure rules for all dwelling-secured credit transactions may offset the compliance burdens associated with the change.[117]

2. *Parties Covered*. Currently, TILA covers "creditors" and RESPA covers settlement service providers and imposes cost-disclosure requirements on "lenders." There are two aspects to party coverage. The first looks at the person to whom the obligation is initially made payable. Under TILA, the initial payee is the creditor. RESPA generally applies the same test but distinguishes two types of transactions (dealer loans and certain mortgage-brokered loans) where the initial payee is not considered to be the lender. In these transactions, the obligations are assigned at or immediately after closing to the person providing the funds, and the assignee--not the initial payee--is the lender.[118]

Additionally, creditors must "regularly" extend credit (more than five dwelling-secured loans annually) to be covered under TILA.[119] To be covered under RESPA, the lender must extend credit for "federally related mortgage loans." Because this term broadly includes not only loans related to federally regulated institutions, including those with insured deposits, but any loans that might be sold to Fannie Mae or Freddie Mac, the effect is to except from coverage only individuals such as a homeowner taking back a mortgage as part of a sale, or occasional investors, defined by RESPA as a TILA creditor making or investing

[116] Temporary loans, such as construction loans, and loans secured by vacant land or by property of twenty-five acres or more are excluded from coverage by HUD's regulations.

[117] If TILA's dwelling-secured standard were adopted, construction loans involving a dwelling would be covered. RESPA's exemption for transactions involving property of twenty-five and more acres would be eliminated. This exemption was created to facilitate farm loans.

[118] Under current RESPA rules, mortgage brokers in table-funded transactions are not treated as lenders. Similarly, dealers in goods and services who facilitate a borrower loan or contract and assign it to the funding lender are not themselves considered to be lenders.

[119] For HOEPA loans, a lower threshold applies: A person is a TILA creditor if more than one HOEPA-covered loan is extended in a twelve-month period, or if one is extended through a broker.

in real estate-secured loans aggregating $1 million or less annually. Coverage under the two statutes is shown in the figure below.

Figure 3. General coverage criteria for TILA and RESPA

TILA	RESPA
General rule: Does the party extend credit secured by a dwelling more than five times a year? HOEPA loans: Does the party making the loan with rates and fees above a certain threshold extend credit secured by a primary dwelling more than once in any twelve-month period or one time through a broker?	Is the loan* ·made by a lender that is federally regulated or has federally insured deposits or accounts ·made by or insured, guaranteed, supplemented or assisted by a federal program ·intended to be sold to Fannie Mae (and other secondary market investors) ·made by a TILA "creditor" that makes or invests in residential real estate loans aggregating more than $1 million per year?
Is the credit secured by a residential structure containing one to four family housing units?	Is the loan secured by residential real property on which a structure designed primarily for occupancy of one to four families is located or will be constructed or placed using proceeds of the loan?

*By regulation, RESPA also covers loans originated by a dealer or mortgage broker and assigned to a party that is a RESPA lender, and reverse mortgages issued by any party that is a RESPA lender.

The TILA approach of imposing disclosure duties on the person "to whom the note is made payable" is simple and certain for creditors. RESPA, as implemented by Regulation X, is more complicated, resulting from an attempt to achieve the earliest possible delivery of disclosures, even if the person providing the disclosures is not considered to be the lender. The Board and HUD recommend that an annual minimum number of transactions test be established. Such a rule could capture additional loans of small investors which may now elude coverage under RESPA's dollar amount test (making or investing in more than $1 million of covered loans). The Board believes that the numerical trigger in TILA's coverage provision (currently when an entity makes more than 5 dwelling-secured loans annually) is appropriate for most loans, but that the HOEPA's current threshold should be retained.

3. *Expanding Coverage to Mortgage Brokers*. Mortgage brokers often have the first and most regular contact with the consumer. They play an increasingly large role in the loan origination process and it seems appropriate for them to provide the initial disclosures to consumers (they are already required to make RESPA disclosures under current RESPA rules but are not required to provide TILA disclosures). This could be accomplished by defining mortgage brokers to be "creditors" for disclosure purposes (with liability for violations),

whether or not the note was initially made payable to them.[120] This approach would simplify many aspects of disclosure. For example, fees charged by mortgage brokers in all cases would be treated the same as fees charged by the lending entity for purposes of determining the finance charge or other cost disclosures.

In crafting a definition for purposes of the disclosure requirement, care should be taken not to alter the definition of "mortgage brokers" for other RESPA requirements.[121] Since the loan origination process is certain to evolve, the definition of "mortgage broker" should be flexible enough to accommodate changes in the types of entities that may broker loans.

In summary, the agencies believe the two statutes' coverage should be harmonized by covering "dwelling-secured" transactions, defining "dwelling" as a one to four family residential structure.[122] Regarding the coverage of parties, the Board recommends that the statutes cover the person to whom the note is made payable, if annually that person regularly makes dwelling-secured loans (more than five annually) or makes two or more HOEPA-covered loans; HUD recommends that the statutes apply for any person that funds annually two or more dwelling-secured loans. The Board and HUD believe that mortgage brokers taking applications (regardless of whether they are the person to whom the note is made payable and whether they may be subject to different RESPA requirements) should be required to provide disclosures if they meet the same numerical tests as other parties covered by TILA and RESPA.

C. Remedies under RESPA

As currently framed, RESPA establishes limited and inconsistent enforcement authority. Designated governmental agencies and officials may enforce § 8 (illegal referrals), § 9 (improper title insurance practices), § 10 (escrow accounts) and arguably § 6 (loan

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[120] The Board's Regulation B implements the Equal Credit Opportunity Act, which prohibits creditors from discriminating against applicants because of a prohibited basis with respect to any aspect of a credit transaction (15 U.S.C. § 1691(a) (1994 & Supp. 1996)). For limited purposes, a creditor under Regulation B includes persons such as real estate brokers who regularly refer applicants to creditors or who select or offer to select creditors to whom credit requests can be made (12 C.F.R. § 202.2(l) (1997)).

[121] RESPA's Regulation X defines mortgage broker as a person, other than an employee or exclusive agent of the creditor, who brings the borrower and creditor together to obtain a loan and who renders settlement services. HUD's proposed mortgage broker rule would establish for mortgage brokers entering into contracts with consumers specific requirements detailing their functions and fees. See appendix F.

[122] HUD had previously taken the position that individuals acquiring otherwise qualifying property for the purpose of rental should be covered by RESPA. The recent enactment of § 7 of RESPA effectively removed this coverage, and RESPA now uses the "business purpose" test of TILA, which excepts rental houses from coverage. HUD believes the Congress may want to reconsider whether such properties should have RESPA and TILA protections, at least in the case of transactions by individuals.

servicing requirements) of the current statute. Public enforcement is primarily in the nature of injunctive authority, although § 8 also permits criminal penalties and § 10 permits civil money penalties. In addition, §§ 6, 8, and 9 provide some borrower remedies, although authority for private causes of action is sometimes ambiguous. This limited authorization of private causes of action restricts enforcement activities because HUD, as the primary public enforcer of RESPA, receives a volume of complaints in excess of its enforcement capacity.

Some of the most important consumer provisions included in RESPA are unenforceable. Requirements relating to the GFE and Special Information Booklet (§ 5) and the HUD-1 uniform settlement statement (§ 4) are not supported by any enforcement authority under RESPA. The lack of accurate, quality information early in the homebuying process is a primary concern that has impelled a review of the RESPA protections. Even without comprehensive legislation that would redefine the mortgage lending industry in any of the ways reviewed in this report, the original purpose of RESPA could be better achieved, HUD believes, if all of its requirements could be enforced.

The present remedies under RESPA are deficient in a number of respects. HUD recommends a simplified and streamlined system of remedies that would apply, unless specifically noted, to all violations of RESPA, both to the new provisions recommended by this report and the existing requirements of RESPA.

The most obvious deficiency in enforcement authority relates to the GFE. Currently, the statute requires that the GFE be furnished, but does not provide remedies for nondelivery. More significantly, there is a compelling need to ensure effective use of the GFE to provide the information and assurances that the consumer must have to be satisfied with the final mortgage transaction. Chapter 3 of this report discusses approaches that could encourage accurate information on the GFE (or a new substitute form), including defining a tolerance level for costs listed on the GFE. If charges at settlement exceed the estimated costs-plus-tolerance, the generally applicable remedies, discussed below in this chapter, would then be available.

Section 8 (Prohibition Against Kickbacks and Unearned Fees) provides the only criminal sanctions under RESPA. Such sanctions have rarely been pursued. The United States Attorneys' offices and the Department of Justice's Criminal Division have, understandably, been reluctant to devote resources to misdemeanor cases. HUD believes, nonetheless, that the potential for criminal penalties has been a significant deterrent to violations of § 8, and that such sanctions, when used in a limited number of cases, have been appropriate.

Section 8(a) of RESPA prohibits any person from giving or accepting any fee, kickback, or thing of value for the referral of settlement service business involving a federally related mortgage loan. The term "thing of value" is defined in § 3 of RESPA to include any payment, advance, funds, loan, service, or other consideration. HUD has interpreted § 8 as prohibiting positive incentives for the referral of settlement service business, but has interpreted RESPA as being silent regarding *disincentives*.[123] HUD receives complaints that real estate agents lack a direct remedy under RESPA when they: (1) do not refer consumers to affiliated businesses and are unable to have their desk fees waived (while agents referring business do get desk fees waived); and (2) are paid a smaller commission than agents that agree to refer the business. As a practical matter, practices that implement financial disincentives have the same effect as giving positive "things of value" for referring business; HUD proposes that § 8(a) be amended to clarify that certain disincentives also violate RESPA.

There are also inadequate remedies for violations of RESPA's requirements for escrow accounts. Most creditors require borrowers to establish an escrow account at settlement and to maintain an account during the life of the mortgage loan. Although the service is currently required under Regulation X to submit an escrow statement within 60 days of loan payoff, there is no express requirement that a service return escrow funds under these circumstances within any particular time frame. This often creates a financial hardship for borrowers who are refinancing their mortgage loans and must place escrow funds in the new account while the old service retains the existing escrow account balance.

RESPA could be amended to require loan servicers to credit escrow funds toward the loan payoff amount, or transfer the escrow account funds to the new creditor/service in the case of refinancing, or return the balance of funds in the escrow account, or any other account, within a specific time frame or else face an immediate penalty. Funds returned later than the specific time frame could also include an interest rate penalty, which could be established by regulation or notice, such as twice the one year T-bill rate or other index.

RESPA requires servicers to pay escrow items such as taxes and insurance in a timely manner, but does not provide any specific remedy or penalty for the failure to do so, other than by means of a private law suit. Some servicers fail to make disbursements from a borrower's escrow accounts. In recent cases, this has caused tax penalties to be incurred that are passed through to consumers without their knowledge. Such failures to perform result in higher costs to consumers.

Servicers sometimes force-place hazard insurance resulting in greater premiums for consumers. Servicers should not be allowed to profit from force-placing insurance when their omissions or untimely payment occasioned the lapse. RESPA could be amended to clarify that the loan servicer is liable for any penalties assessed or increased charges due to a late payment of escrow items resulting from the servicer's negligence. In addition, the

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[123] Statement of Policy 1996-3, Rental of Office Space, Lock-outs, and Retaliation (Dept. of Hous. and Urban Dev. 1996).

servicer should be prohibited from receiving any portion of the charge, rebate, or any other fee associated with force-placed hazard insurance.

Consumers and businesses would benefit from clearer and more comprehensive remedies for RESPA violations, whether or not the statute is otherwise modified. Consolidating the remedies for violations of new and current provisions in RESPA into a separate section would promote clarity in the statute. Widespread confusion about the effect of statutory requirements for which there are no real mandates would be avoided by providing remedies for violation of those requirements. Noncomplying settlement service providers would, for the first time, face the prospect of legal action for their failures to comply. This would alleviate the competitive disadvantage placed upon those providers that properly, but in effect voluntarily, comply with current "toothless" requirements.

The Congress must consider how compliance with any new combined disclosure under RESPA and TILA is to be enforced, particularly if entities other than creditors are authorized to package or deliver disclosure documents. The Congress could give jurisdictional authority for enforcing a new RESPA/TILA disclosure to HUD, the Board, other Federal and state bank regulators, or all such agencies concurrently.

HUD recommends the following specific suggestions for improving the remedies available under RESPA:

- *Expand injunctive authority of public enforcers*: Authorize HUD, State Attorneys General, and state financial regulators (such as banking commissions) to bring actions to enjoin any violation of RESPA.

- *Expand HUD's civil remedies*: Authorize HUD to assess civil money penalties for any violation of RESPA, including any new requirements such as those related to packaged costs. Specify that civil money penalties collected under RESPA shall be paid to HUD and, upon approval in an appropriations law, may be used by HUD to cover costs for RESPA enforcement. Suggested amounts: $1,000 per violation, with a $1 million cap in any twelve-month period.

- *Strengthen criminal sanctions for § 8 violations, only*: Update the current 1 year/$10,000 penalties.

- *Expand remedies available through private causes of action*: Authorize a consumer who may have been harmed by a violation of RESPA to seek three times the amounts charged for any settlement service for which a violation is found. Also permit private causes of action for damages, specific performance, reasonable attorneys fees and costs, and any other relief as the court would deem just and equitable (e.g., enforcement of creditor responsibilities when tolerance level in GFE or combined GFE/TILA document is exceeded).

- *Provide penalties for servicers who negligently or intentionally fail to make timely disbursements from escrow accounts and prohibit servicers from receiving any portion of any charge, rebate, or any other fee from force-placed insurance resulting from such failures*: RESPA should also require that servicers return escrow funds after loan payoff within a specified time frame.

- *Consider recognizing a competitor's right to sue for injunctive relief or damages for violations of* §§ *8 and 9*: This right would be limited to violations of these two sections. There is no comparable authority under RESPA currently. A competitor is often the source of information about potential violations of RESPA, and often is at a competitive disadvantage because of the illegal actions of the alleged violator. The danger of abusive or nuisance lawsuits could be mitigated by allowing the prevailing party to recover attorneys' fees and costs.

- *Standardize the statute of limitations*: The current limitations on actions under RESPA can have an adverse effect on the enforcement of those provisions for which remedies have been provided. The statute of limitations applicable to private causes of action often may run before the consumer is able to detect and define a violation that may have occurred. In addition, there are different limitation periods applicable to actions brought by private complainants, depending on which section of the statute is alleged to have been violated. HUD believes that enforcement efforts would be enhanced, and the requirements of the statute would be simplified, by standardizing the statute of limitations. HUD recommends that the statute of limitations for all private causes of action under RESPA be changed to three years, and to six years for actions brought by HUD, state Attorneys General, and state financial regulators (e.g., Banking Commissioners).

Board of Governors of the Federal Reserve System
Department of Housing and Urban Development

Appendices

Table of Contents for Forms

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate.	FINANCE CHARGE The dollar amount the credit will cost you.	Amount Financed The amount of credit provided to you or on your behalf.	Total of Payments The amount you will have paid after you have made all payments as scheduled.
8.19 %	$ 218,365	$ 129,103	$347,468

You have the right to receive at this time an itemization of the Amount Financed.
☐ I want an itemization. ☐ I do not want an itemization.

Your payment schedule will be:

Number of Payments	Amount of Payments	When Payments Are Due
360	$ 965.18	Monthly beginning April 1, 1998

Insurance
Credit life insurance and credit disability insurance are not required to obtain credit, and will not be provided unless you sign and agree to pay the additional cost.

Type	Premium	Signature
Credit Life		I want credit life insurance. _______ Signature
Credit Disability		I want credit disability insurance. _______ Signature
Credit Life and Disability		I want credit life and disability insurance. _______ Signature

You may obtain property insurance from anyone you want that is acceptable to (creditor). If you get the insurance from (creditor), you will pay $ _______.

Security: You are giving a security interest in:
☒ the goods or property being purchased.
☐ (brief description of other property).

Filing fees $ _______ Non-filing insurance $ _______

Late Charge: If a payment is late, you will be charged $ _______ / _______ % of the payment.

Prepayment: If you pay off early, you
☐ may ☒ will not have to pay a penalty.
☐ may ☐ will not be entitled to a refund of part of the finance charge.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

e means an estimate

GOOD FAITH ESTIMATE

PRELIMINARY MORTGAGE LOAN DISCLOSURE STATEMENT

This list gives an estimate of most of the charges you will have to pay at settlement of your loan. The figures shown are estimates and are subject to change. The figures shown are computed based on a sales price of $ 155,000 and a proposed mortgage amount of $ 135,000 as stated on your loan application.

ESTIMATED SETTLEMENT CHARGES

801	Loan Origination Fee (.5 %)	675	1101	Settlement Fee	
802	Loan Discount (1 %)	1350	1102	Title Search	200
803	Appraisal	250	1103	Title Exam	50
804	Credit Report	35	1104	Title Binder	50
805	Inspection Fee		1105	Doc. Prep. Fee	175
806	VA Funding Fee		1106	Notary Fee	15
807	Assumption Fee		1107	Attorney Fee	375
808	Application Fee	100		To:	
809	Mortgage Broker	675	1108	Title Insurance	350
810			1111	Flood Certification	25
			1112	Tax Certification	25
	Interest 30 days @ 27.74 / day	$ 832	1113		
	Private Mortgage Insurance ___ %	255	1201	Recording Fees	
902	FHA MIP Insurance		1202	City/County Stamps	
903	Hazard Insurance $	500	1203	State Stamps	
904			1204		
905			1205		
1001	Hazard Insurance Resv.		1301	Survey	175
1002	Mortgage Insurance Resv.		1302	Pest Inspection	50
1003	Tax Reserve ___ Months		1303	Courier Fee	35
1004	Tax Reserve ___ Months		1304	Property Inspection	200
1005	Assessments		1305		
1006	Taxes	1000			
1007					
1008			1400	TOTAL LOAN COSTS & RESERVES	$ 7397

A. Settlement Statement

B. Type of Loan

1. ☐ FHA 2. ☐ FmHA 3. ☐ Conv. Unins.
4. ☐ VA 5. ☐ Conv. Ins.

6. File Number

7. Loan Number

8. Mortgage Insurance Case Number

C. Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.

D. Name and Address of Borrower

E. Name and Address of Seller

F. Name and Address of Lender

G. Property Location

H. Settlement Agent

Place of Settlement

I. Settlement Date

J.	Summary of Borrower's Transaction	
100.	Gross Amount Due From Borrower	
101.	Contract sales price	
102.	Personal property	
103.	Settlement charges to borrower (line 1400)	
104.		
105.		
	Adjustments for items paid by seller in advance	
106.	City/town taxes to	
107.	County taxes to	
108.	Assessments to	
109.		
110.		
111.		
112.		
120.	Gross Amount Due From Borrower	
200.	Amounts Paid By Or In Behalf Of Borrower	
201.	Deposit or earnest money	
202.	Principal amount of new loan(s)	
203.	Existing loan(s) taken subject to	
204.		
205.		
206.		
207.		
208.		
209.		
	Adjustments for items unpaid by seller	
210.	City/town taxes to	
211.	County taxes to	
212.	Assessments to	
213.		
214.		
215.		
216.		
217.		
218.		
219.		
220.	Total Paid By/For Borrower	
300.	Cash At Settlement From/To Borrower	
301.	Gross Amount due from borrower (line 120)	
302.	Less amounts paid by/for borrower (line 220)	( )
303.	Cash ☐ From ☐ To Borrower	

K.	Summary of Seller's Transaction	
400.	Gross Amount Due To Seller	
401.	Contract sales price	
402.	Personal property	
403.		
404.		
405.		
	Adjustments for items paid by seller in advance	
406.	City/town taxes to	
407.	County taxes to	
408.	Assessments to	
409.		
410.		
411.		
412.		
420.	Gross Amount Due To Seller	
500.	Reductions in Amount Due To Seller	
501.	Excess deposit (see instructions)	
502.	Settlement charges to seller (line 1400)	
503.	Existing loan(s) taken subject to	
504.	Payoff of first mortgage loan	
505.	Payoff of second mortgage loan	
506.		
507.		
508.		
509.		
	Adjustments for items unpaid by seller	
510.	City/town taxes to	
511.	County taxes to	
512.	Assessments to	
513.		
514.		
515.		
516.		
517.		
518.		
519.		
520.	Total Reduction Amount Due Seller	
600.	Cash At Settlement To/From Seller	
601.	Gross Amount due to seller (line 420)	
602.	Less reductions in amt. due seller (line 520)	( )
603.	Cash ☐ To ☐ From Seller	

L. Settlement Charges			Page 2
700.	Total Sellers/Broker's Commission based on price $	Paid From Borrowers Funds at Settlement	Paid From Seller's Funds at Settlement
	Division of Commission (line 700) as follows:		
701.	$ to		
702.	$ to		
703.	Commission paid at Settlement		
704.			
800.	Items Payable in Connection With Loan		
801.	Loan Origination Fee %		
802.	Loan Discount %		
803.	Appraisal Fee to		
804.	Credit Report to		
805.	Lender's Inspection Fee		
806.	Mortgage Insurance Application Fee to		
807.	Assumption Fee		
808.			
809.			
810.			
811.			
900	Items Required by Lender To Be Paid In Advance		
901.	Interest from to @ $ /day		
902.	Mortgage Insurance Premium for months to		
903	Hazard Insurance Premium for years to		
904.	years to		
905.			
1000.	Reserves Deposited With Lender		
1001.	Hazard Insurance months @ $ per month		
1002.	Mortgage Insurance months @ $ per month		
1003.	City property taxes months @ $ per month		
1004	County property taxes months @ $ per month		
1005.	Annual assessments months @ $ per month		
1006.	months @ $ per month		
1007.	months @ $ per month		
1008	months @ $ per month		
1100.	Title Charges		
1101.	Settlement or closing fee to		
1102	Abstract or title search to		
1103	Title examination to		
1104	Title insurance binder to		
1105	Document preparation to		
1106	Notary fees to		
1107	Attorney's fees to		
	(includes above items numbers:)		
1108.	Title insurnace to		
	(includes above items numbers:)		
1109	Lender's coverage $		
1110	Owner's coverage $		
1111			
1112			
1113			
1200	Government Recording and Transfer Charges		
1201	Recording fees: Deed $; Mortgage $; Releases $		
1202	City/county tax/stamps: Deed $; Mortgage $		
1203	State tax/stamps: Deed $; Mortgage $		
1204			
1300.	Additional Settlement Charges		
1301.	Survey to		
1302	Pest inspection to		
1303.			
1304.			
1305.			
1400.	Total Settlement Charges (enter on Lines 103, Section J and 502, Section K)		

Federal Disclosure Statement for Home-Secured Loans

BORROWERS: Mary and James Focus

CREDITOR: ABC Bank

PROPERTY ADDRESS: 3 Group Lane, Homeloan, MD 20790

DATE: 3/1/99

LOAN NO.: 123

LOAN AMOUNT	INTEREST RATE	REQUIRED CLOSING COSTS (including points)	MONTHLY PAYMENT
You are borrowing $ 135,000 .	Your interest rate is 7.5 % . ☒ fixed ☐ variable*	We will guarantee a package of services required by us for $ 4,860 . These costs plus other required closing costs are estimated to total $ 8,400.54 and are itemized on the next page.	Your monthly principal and interest payment is $ 943.94 .

* If checked, your loan contains a variable rate feature. During the term of your loan, the highest your interest rate could increase is to ____%, resulting in monthly payments of $________. See the variable rate disclosures separately provided to you for further information about how your rate, payment, and loan term may be adjusted.

Finance Charge and Annual Percentage Rate (APR): The dollar cost of borrowing $ 135,000 for 30 years is $ 207,752.26 (the finance charge). The cost of credit as a yearly rate (the APR) is 7.73 % . The APR reflects interest and other packaged services (including points) required to obtain the loan. You can use the APR to compare loan products among different lenders.

Your Scheduled Payments for Principal and Interest Will Be:

Number of payments	Monthly payments	Total of scheduled payments
360	$ 943.94** beginning June 1, 1999	$ 339,818.40

** This amount does not include taxes or hazard insurance.

Security: Your home is the security for this loan. **You may lose your home** if you do not make your payments.

Late Charge: If a payment is late, you will be charged $ 25 .

Prepayment Penalty: If you pay your loan off early, you ☐ will be charged a penalty.
☒ will not be charged a penalty.

Transfer of Servicing: We may assign, sell or transfer the servicing of your loan (the right to collect payments from you).

Private Mortgage Insurance (PMI): PMI ☐ is required for your loan.
You ☐ may cancel when your balance is ___% of the home's value, or by paying an additional fee of $__________ .
You ☐ may not cancel PMI.
☒ is not required for your loan.

Escrow Account: You ☒ will be required to have an escrow account for the payment of taxes and hazard insurance.
You ☐ may pay $__________ to cancel the escrow requirement.
You ☐ may not cancel the escrow requirement.
☐ will not be required to have an escrow account.

Itemization of Closing Costs

Packaged Services: The cost of these services may vary from lender to lender. The maximum amount you will pay for services, [listed in this section,] that may be needed for this loan is $4,860. The actual services performed will be indicated on your final Settlement Statement (HUD-1).

Application Fee	Settlement Fee		
Appraisal Fee	State Tax Stamps		
Assumption Fee	Survey		
Attorney's Fee	Tax Certification		
Courier Fee	Title Exam		
Credit Report	Title Insurance		
Document Preparation	Title Insurance Binder		
Flood Certification	VA Funding Fee	**Subtotal**	$ 2,835.00
Lender's Inspection Fee			
Mortgage Broker Fee			
Notary Fee	Points		
Pest Inspection	Loan Origination Fee ($675.00)		
Recording Fee	Discount Points ($1,350.00)		$ 2,025.00
		TOTAL	$ 4,860.00

The rate for this loan with the above closing cost is 7.5 %. If you do not lock-in this rate, the rate and points may change in accordance with changes in market rates. Furthermore, the rate and points are guaranteed subject to verification of property information and information supplied in your application.

Other Required Closing Costs: These costs may vary depending on when you close the loan, the lock-in interest rate, how much insurance you obtain, and the tax rate in your jurisdiction.

Interest 30 days @ 27.74/day	832.20
Hazard Insurance Premium for 12 months	500.00
School Property Taxes	500.00
County Property Taxes	1,500.00
Reserves/Escrow:	
Hazard Insurance	41.67
School Property Taxes	41.67
County Property Taxes	125.00
Annual Assessments	
Aggregate Adjustment	
Total Required Closing Costs:	8,400.54

Optional Costs: These costs may vary depending on the provider and the level of service you choose. **You are not required to purchase any of these services.**

Owner's Title Insurance	100 00
Credit Life/Disability Insurance for 12 months	420 00

A. Settlement Statement

B. Type of Loan	6. File Number	7. Loan Number	8. Mortgage Insurance Case Number
☐ FHA 2. ☐ FmHA 3. ☑ Conv. Unins. ☐ VA 5. ☐ Conv. Ins.		123	

C. Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.

D. Name and Address of Borrower	E. Name and Address of Seller	F. Name and Address of Lender
Mary and James Focus 3 Group Lane Homeloan, MD 20790	Susan and Peter Seller 10 Retirement Blvd. Scotsdale, AZ 40000	ABC Bank 100 Money Lane Homeloan, MD 20790

G. Property Location	H. Settlement Agent	
3 Group Lane Homeloan, MD 20790	Esquire Services	
	Place of Settlement Homeloan, MD 20790	I. Settlement Date 4/1/99

J.	Summary of Borrower's Transaction		K.	Summary of Seller's Transaction	
100	Gross Amount Due From Borrower		400.	Gross Amount Due To Seller	
101	Contract sales price		401.	Contract sales price	
102	Personal property		402.	Personal property	
103	Settlement charges to borrower (line 1500)		403.		
104			404.		
105			405.		
	Adjustments for items paid by seller in advance			Adjustments for items paid by seller in advance	
106	City/town taxes to		406.	City/town taxes to	
107	County taxes to		407.	County taxes to	
108	Assessments to		408.	Assessments to	
109			409.		
110			410.		
111			411		
112			412.		
120	Gross Amount Due From Borrower		420.	Gross Amount Due To Seller	
200	Amounts Paid By Or In Behalf Of Borrower		500.	Reductions in Amount Due To Seller	
201	Deposit or earnest money		501.	Excess deposit (see instructions)	
202	Principal amount of new loan(s)		502.	Settlement charges to seller (line 1500)	
203	Existing loan(s) taken subject to		503.	Existing loan(s) taken subject to	
204			504.	Payoff of first mortgage loan	
205			505.	Payoff of second mortgage loan	
206			506.		
207			507.		
208			508.		
209			509.		
	Adjustments for items unpaid by seller			Adjustments for items unpaid by seller	
210	City/town taxes to		510.	City/town taxes to	
211	County taxes to		511.	County taxes to	
212	Assessments to		512.	Assessments to	
213			513		
214			514		
215			515		
216			516		
217			517		
218			518		
219			519		
220	Total Paid By/For Borrower		520	Total Reduction Amount Due Seller	
300	Cash At Settlement From/To Borrower		600.	Cash At Settlement To/From Seller	
301	Gross Amount due from borrower (line 120)		601.	Gross Amount due to seller (line 420)	
302	Less amounts paid by/for borrower (line 220)	( )	602.	Less reductions in amt. due seller (line 520)	( )
303	Cash ☐ From ☐ To Borrower		603.	Cash ☐ To ☐ From Seller	

L. Settlement Charges

		Paid From Borrowers Funds at Settlement	Paid From Seller's Funds at Settlement
700.	Total Sellers/Broker's Commission based on price $		
	Division of Commission (line 700) as follows:		
701.	$ to		
?.	$ to		
,.	Commission paid at Settlement		
/04.			
800.	Items Payable in Connection With Loan		
801.	Loan Origination Fee %	√	
802.	Loan Discount 1 %	√	
803.	Appraisal Fee	√	
804.	Credit Report	√	
805.	Lender's Inspection Fee	√	
806.	Mortgage Insurance Application Fee to		
807.	Assumption Fee		
808.	Mortgage Broker Fee	√	
809.	Application Fee	√	
810.	Document Preparation Fee	√	
811.	Flood Certification Fee	√	
812.	Tax Certification	√	
900.	Items Required by Lender To Be Paid In Advance		
901.	Interest from 4/1 to 4/30 @ $ 27.74 / day	832.20	
902.	Mortgage Insurance Premium for months to		
903.	Hazard Insurance Premium for 1 years to Insure All	500.00	
904.	School Property Taxes years to	500.00	
905.	County Property Taxes	1,500.00	
1000.	Reserves Deposited With Lender		
1001.	Hazard Insurance 1 months @ $ 41 67 per month	41.67	
1002.	Mortgage Insurance months @ $ per month		
1003.	City Property Taxes months @ $ per month		
`4.	County Property Taxes 1 months @ $ 125 00 per month	125.00	
.5.	Annual Assessments months @ $ per month		
1006.	School Property Taxes 1 months @ $ 41 67 per month	41.67	
1007.			
1008.	Aggregate Adjustment		
1100.	Title Charges		
1101.	Settlement or Closing Fee to		
1102.	Abstract or Title Search		
1103.	Title Examination	√	
1104.	Title Insurance Binder	√	
1105.	Document Preparation to		
1106.	Notary Fees to		
1107.	Attorney's Fees	√	
	(includes above items numbers:)		
1108	Title Insurance		
	(includes above items numbers:)		
1109	Lender's coverage $ 135,000	√	
1110.	Owner s Coverage		
1111			
1200	Government Recording and Transfer Charges		
1201	Recording fees: Deed	√	
1202	City/County Tax/Stamps: Deed $; Mortgage $		
1203	State Tax/Stamps: Deed $; Mortgage $		
1204	Recording Fees: Mortgage and Releases	√	
1205			
⁻00	Additional Settlement Charges		
1.	Survey	√	
ᴊ02.	Pest Inspection	√	
1303	Couner Fee	√	
1304.	Notary Fees	√	
1305.			
1400.	Guaranteed Costs for Packaged Services (This is the total amount for the items (√) checked.)	4,860.00	
1500	Total Settlement Charges (enter on lines 103, Section J and 502, Section K)	8,400.54	

GFE
Page 1

Federal Disclosure Statement for Home-Secured Loans

BORROWERS: Mary and James Focus

CREDITOR: ABC Bank

PROPERTY ADDRESS: 3 Group Lane, Homeloan, MD 20790

DATE: 3/1/99

LOAN NO.: 123

LOAN AMOUNT	INTEREST RATE	REQUIRED CLOSING COSTS (including points)	MONTHLY PAYMENT
You are borrowing $ 135,000 .	Your interest rate is 7.5 %. X fixed _ variable*	Your required closing costs (inicuding points) are itemized on the next page and are estimated to total $ 8,400.54 , excluding downpayment (if any).	Your monthly principal and interest payment is $ 943.94 .

* If checked, your loan contains a variable rate feature. During the term of your loan, the highest your interest rate could increase is to ____%, resulting in monthly payments of $________. See the variable rate disclosures separately provided to you for further information about how your rate, payment, and loan term may be adjusted.

Finance Charge and Annual Percentage Rate (APR): The dollar cost of borrowing $ 135,000 for 30 years is $ 207,752.26 (the finance charge). The cost of credit as a yearly rate (the APR) is 7.73 %. The APR reflects interest (including points) and other costs required to obtain the loan. Taxes, escrow amounts and hazard insurance premiums are not included. You can use the APR to compare loan products among different lenders.

Your Scheduled Payments for Principal and Interest Will Be:

Number of payments	Monthly payments	Total of scheduled payments
360	$ 943.94** beginning June 1, 1999	$ 339,818.40

** This amount does not include taxes or hazard insurance

Security: Your home is the security for this loan. **You may lose your home** if you do not make your payments.

Late Charge: If a payment is late, you will be charged $ 25 .

Prepayment Penalty: If you pay your loan off early, you
_ will be charged a penalty.
X will not be charged a penalty.

Transfer of Servicing: We may assign, sell or transfer the servicing of your loan (the right to collect payments from you).

Private Mortgage Insurance (PMI): PMI
_ is required for your loan.
You _ may cancel when your balance is ___% of the home's value, or by paying an additional fee of $__________.
You _ may not cancel PMI.
X is not required for your loan.

Escrow Account: You
X will be required to have an escrow account for payment of taxes and hazard insurance.
You _ may pay $__________ to cancel the escrow requirement.
You _ may not cancel the escrow requirement.
_ will not be required to have an escrow account.

Itemization of Closing Costs

Required Closing Costs: The amounts listed below are estimates of the costs you may have to pay to close your loan.

Application Fee	100.00
Appraisal Fee	250.00
Assumption Fee	
Attorney's Fee	375.00
Courier Fee	35.00
Credit Report	35.00
Document Preparation	175.00
FHA MIP Insurance	
Flood Certification	25.00
Recording Fees (Deed, Mortgage, Release)	75.00
Lender's Inspection Fee	200.00
Mortgage Broker Fee	650.00
Notary Fee	15.00
Pest Inspection	50.00
Private Mortgage Insurance	
Settlement Fee	
State Tax Stamps	
Survey	175.00
Tax Certification	25.00
Title Exam	250.00
Title Insurance	350.00
Title Insurance Binder	50.00
Transfer Tax	
VA Funding Fee	

Points:

Loan Origination Fee	675.00
Discount Points (1 point = 1% of loan amount)	1,350.00 *
Interest 30 days @ 27.74/day	832.20 *
Hazard Insurance Premium for 12 months	500.00 *
School Property Taxes	500.00 *
County Property Taxes	1,500.00 *

Reserves/Escrow:

Hazard Insurance	41.67 *
School Property Taxes	41.67 *
County Property Taxes	125.00 *
Annual Assessments	*
Aggregate Adjustment	

Total Required Closing Costs: 8,400.54

* These costs may vary depending on when you close the loan, the lock-in interest rate, how much insurance you obtain, and the tax rate in your jurisdiction.

Optional Costs: These costs may vary depending on the provider and the level of service you choose. **You are not required to purchase any of these services.**

Owner's Title Insurance	100.00
Credit Life/Disability Insurance for 12 months	420.00

A. Settlement Statement

Page 1

B. Type of Loan

☐ FHA 2. ☐ FmHA 3. ☑ Conv. Unins. ☐ VA 5. ☐ Conv. Ins.	6. File Number	7. Loan Number 123	8. Mortgage Insurance Case Number

C. Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.

D. Name and Address of Borrower	E. Name and Address of Seller	F. Name and Address of Lender
Mary and James Focus 3 Group Lane Homeloan, MD 20790	Susan and Peter Seller 10 Retirement Blvd. Scotsdale, AZ 40000	ABC Bank 100 Money Lane Homeloan, MD 20790

G. Property Location	H. Settlement Agent	
3 Group Lane Homeloan, MD 20790	Esquire Services Place of Settlement Homeloan, MD 20790	I. Settlement Date 4/1/99

J. Summary of Borrower's Transaction		K. Summary of Seller's Transaction	
100. Gross Amount Due From Borrower		400. Gross Amount Due To Seller	
101. Contract sales price		401. Contract sales price	
102. Personal property		402. Personal property	
103 Settlement charges to borrower (line 1400)		403.	
104.		404.	
105.		405.	
Adjustments for items paid by seller in advance		Adjustments for items paid by seller in advance	
106 City/town taxes to		406. City/town taxes to	
107. County taxes to		407. County taxes to	
108. Assessments to		408. Assessments to	
109.		409.	
110.		410.	
		411.	
2		412.	
120 Gross Amount Due From Borrower		420. Gross Amount Due To Seller	
200 Amounts Paid By Or In Behalf Of Borrower		500. Reductions in Amount Due To Seller	
201 Deposit or earnest money		501. Excess deposit (see instructions)	
202 Principal amount of new loan(s)		502. Settlement charges to seller (line 1400)	
203 Existing loan(s) taken subject to		503. Existing loan(s) taken subject to	
204		504. Payoff of first mortgage loan	
205		505 Payoff of second mortgage loan	
206		506	
207		507.	
208		508.	
209		509.	
Adjustments for items unpaid by seller		Adjustments for items unpaid by seller	
210 City/town taxes to		510. City/town taxes to	
211 County taxes to		511. County taxes to	
212 Assessments to		512. Assessments to	
213		513.	
214		514.	
215		515.	
216		516.	
217		517.	
218		518.	
219		519.	
Total Paid By/For Borrower		520. Total Reduction Amount Due Seller	
300 Cash At Settlement From/To Borrower		600. Cash At Settlement To/From Seller	
301 Gross Amount due from borrower (line 120)		601. Gross Amount due to seller (line 420)	
302 Less amounts paid by/for borrower (line 220)	( )	602. Less reductions in amt. due seller (line 520)	( )
303 Cash ☐ From ☐ To Borrower		603. Cash ☐ To ☐ From Seller	

L. Settlement Charges

		Paid From Borrowers Funds at Settlement	Paid From Seller's Funds at Settlement
700.	**Total Sellers/Broker's Commission based on price $**		
	Division of Commission (line 700) as follows:		
701.	$ to		
`	$ to		
	Commission paid at Settlement		
704.			
800.	Items Payable in Connection With Loan		
801.	Loan Origination Fee .5 %	675.00	
802.	Loan Discount 1 %	1,350.00	
803.	Appraisal Fee to Property Appraisals Inc.	250.00	
804.	Credit Report to Reporting Agency Inc.	35.00	
805.	Lender's Inspection Fee	200.00	
806.	Mortgage Insurance Application Fee to		
807.	Assumption Fee		
808.	Mortgage Broker Fee to AAA Brokers	650.00	
809.	Application Fee	100.00	
810.	Document Preparation Fee	175.00	
811.	Flood Certification Fee	25.00	
812.	Tax Certification	25.00	
900	Items Required by Lender To Be Paid In Advance		
901.	Interest from 4/1 to 4/30 @ $ 27.74 / day	832.20	
902.	Mortgage Insurance Premium for months to		
903.	Hazard Insurance Premium for 1 years to Insure All	500.00	
904	School Property Taxes years to	500.00	
905.	County Property Taxes	1,500.00	
1000	Reserves Deposited With Lender		
1001.	Hazard Insurance 1 months @ $ 41.67 per month	41.67	
1002.	Mortgage Insurance months @ $ per month		
1003.	City Property Taxes months @ $ per month		
1	County Property Taxes 1 months @ $ 125 00 per month	125.00	
ɔ.	Annual Assessments months @ $ per month		
1006.	School Property Taxes 1 months @ $ 41 67 per month	41.67	
1007.			
1008.	Aggregate Adjustment		
1100.	Title Charges		
1101.	Settlement or Closing Fee to		
1102	Abstract or Title Search to		
1103.	Title Examination to Esquire Services	250.00	
1104	Title Insurance Binder to Esquire Services	50.00	
1105	Document Preparation to		
1106	Notary Fees to		
1107.	Attorney's Fees to Esquire Services	375.00	
	(includes above items numbers)		
1108	Title Insurance to Land Title Insurance Co		
	(includes above items numbers:)		
1109	Lender's coverage $ 135,000	350.00	
1110	Owner's Coverage		
1111			
1112			
1200	Government Recording and Transfer Charges		
1201	Recording fees Deed $ 25 00 ; Mortgage $ 25 00 , Releases $ 25.00	75.00	
1202	City/County Tax/Stamps: Deed $; Mortgage $		
1203	State Tax/Stamps Deed $; Mortgage $		
1204			
⁻⁻05			
.	Additional Settlement Charges		
ɔ1.	Survey to Accurate Lines Inc	175.00	
1302.	Pest Inspection to Pest Free Inspectors	50.00	
1303.	Courier Fee	35.00	
1304	Notary Fees	15.00	
1305			
1400	Total Settlement Charges (enter on lines 103, Section J and 502, Section K)	8,400.54	

You are receiving this special disclosure because this loan's annual percentage rate or closing costs--or both--are high.

You could LOSE YOUR HOME if you take this loan and don't make the payments.

Payment and Income: Your [periodic] payment will be $________.
Your monthly income is $_______.

☐ Variable-rate: Your interest rate may increase. If it does, your payment could increase. The highest it could increase to is $_______.

You have the right not to go through with this loan, even though you signed a loan application or received these disclosures. There may be other creditors that offer other choices. Here's a toll-free number: 1-800-xxx-xxxx. Housing Counselors at HUD* can help.

*Department of Housing and Urban Development, Washington, D.C.

Reform Process

This appendix summarizes the steps the Board and HUD have taken to respond to the Congress's 1996 mandate to reform and simplify TILA and RESPA disclosures.[1]

1. Written Public Comment. In December 1996, the Board and HUD jointly published for comment an advance notice of proposed rulemaking on the issue of simplifying and combining the disclosure requirements of TILA and RESPA.[2] The notice requested comment on regulatory and statutory changes to improve the current disclosure scheme. The agencies received more than eighty comment letters, primarily from creditors and their representatives. Nearly all the recommendations for reconciling the two regulations required legislative action.

Many commenters suggested that to achieve the goal of simplified disclosures, the agencies would have to develop a new disclosure scheme. Commenters urged that the scope of transactions covered by TILA and RESPA, and the timing rules for providing disclosures, be made consistent. They noted that TILA and RESPA reflect differing but related goals and that they need to be harmonized.[3]

Commenters also made recommendations on what information might be disclosed under a new disclosure scheme. Some suggested that the new disclosures should list all the fees paid in connection with the transaction, a simple interest rate and perhaps the APR, and certain terms like the monthly payment amount and escrow amounts. They suggested that all of the other required disclosures--including the amount financed and the finance charge under TILA, and the list of required providers under RESPA--be eliminated.

After reviewing the comments and upon further analysis, the Board and HUD determined that harmonizing TILA and RESPA to any significant degree required changes that can only come about through legislative action. The agencies concluded that minor

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[1] Long before the congressional mandate of September 1996, the Board and HUD were working together to ensure that TILA and RESPA were implemented as consistently as possible. For example, with respect to closed-end transactions, RESPA's definition of "application" triggers certain timing requirements for TILA disclosures, and the GFE and HUD-1 satisfy TILA's itemization of the amount financed. For open-end mortgage transactions, RESPA's Special Information Booklet, the GFE, and HUD-1 are not required if TILA's home-equity brochure and account disclosures are provided.

[2] 61 Fed. Reg. 69,055 (1996).

[3] The goal for some of the disclosures is comparison shopping: these disclosures should be given early, when the consumer is selecting the creditor and loan program, and estimates of costs might suffice. The goal of other disclosures is to highlight certain specific terms or features of the transaction; these disclosures can only be made once the terms of the transaction are agreed to and must be accurate to be useful.

regulatory amendments would not be significant enough to materially improve the disclosures for consumers or to justify the cost of the changes for the industry.

In April 1997, the Board published a notice seeking additional comment on possible statutory changes.[4] More than 180 comments were received. Creditors supported the fundamental reform of TILA and RESPA, seeking clarity and certainty that would provide protection from legal and regulatory actions resulting from complexities of the laws. Consumers and consumer advocates wanted a reform effort that would make disclosures easier for consumers to understand and would provide disclosures early enough to allow shopping among creditors. Consumers also wanted more accurate cost disclosures to avoid the surprise of unexpected charges at the loan closing.

2. *Public Forums*. To supplement written comments, the Board and HUD hosted meetings that addressed various aspects of reform to RESPA and TILA. In July 1997, they jointly sponsored a public forum to give interested parties an opportunity to present their views on the issues of simplifying and reforming the acts.[5] The testimony largely reinforced the views of creditors and consumer advocates already expressed in written comments. Some speakers, however, discussed extensive reforms to the entire disclosure scheme for real-estate-secured lending, such as abandoning the current APR concept in favor of capturing all costs (both dollar- and rate-based) in a single periodic rate that would be applied to the amount borrowed, or requiring lenders to guarantee rates and costs early in the shopping process. Some believed that cost disclosures could be provided earlier and more accurately if creditors were allowed to offer a package of settlement services. Consumer group participants, voicing concern about abusive lending practices, suggested that reform also should include rules to protect consumers against unsuitable loans. Other speakers cautioned the Board and HUD against mere tinkering with the current law and against embracing without serious consideration a different disclosure scheme.

The July forum followed hearings that the Board held in June 1997 in Los Angeles, Atlanta, and Washington, D.C. on home-equity lending and the so-called "high cost" loans covered by the Home Ownership and Equity Protection Act of 1994 (HOEPA)[6] and other TILA issues.[7] Although the focus of the hearings was HOEPA, a portion of each

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4 62 Fed. Reg. 15,624 (1997). The Board's notice also summarized the comments received in response to the earlier request.

5 62 Fed. Reg. 38,489 (1997).

6 15 U.S.C. § 1601 (Supp. II 1996).

7 62 Fed. Reg. 23,189 (1997). HOEPA required that the Board hold hearings within three years after its enactment on the home-equity lending market generally and the adequacy of TILA in protecting consumers targeted by HOEPA, seeking the views of the industry, consumer representatives, and consumers.

was devoted to a discussion of TILA's finance charge and APR. That discussion often turned to issues of broader reform under TILA and RESPA.

*3. **Board Studies**.* Over the past three years, the Board has responded to four Congressional mandates to study subjects under TILA--the finance charge, the right of rescission, the home-equity line of credit rules, and credit advertising. The findings of these studies have been useful background to the present report.

In 1995, the Congress directed the Board to study how the finance charge could be modified to reflect more accurately the cost of consumer credit.[8] Currently, only some costs are considered to be finance charges under TILA and the concept has proven to be problematic over the years. Creditors often have difficulty knowing whether charges are included or excluded from the finance charge, and consumers too can be confused by the calculation. As a result, the Congress directed the Board to study the issue, including the feasibility of placing all costs in the finance charge.[9] The Board submitted a preliminary report in April 1996.[10]

The report discussed the advantages and disadvantages of a more-inclusive definition of the finance charge, based on the Board's own analysis of the issues and considering views expressed by the industry, consumer representatives, and the Board's Consumer Advisory Council. In general terms, creditors offering mortgage loans favored including in the finance charge only fees expressly required by the creditor and expressed concern about being potentially liable for inaccuracies concerning third-party charges over which they have no control. Consumer representatives favored including in the finance charge all fees that the consumer pays, such as fees for home appraisals and optional credit life insurance.

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[8] The Congressional mandate was a part of the Truth in Lending Act Amendments of 1995, 15 U.S.C. § 1601 (Supp 1996). The amendments addressed the liability concerns of mortgage lenders stemming from a 1994 court decision, Rodash v. AIB Mortgage Co. 16 F.3d 1142 (11th Cir. 1994). In that case, the U.S. Court of Appeals for the Eleventh Circuit allowed a consumer to rescind a mortgage loan--and recover all fees and finance charges that had been paid--based on, among other things, errors in the creditor's TILA finance charge disclosures. Subsequently, a number of class-action lawsuits were filed, involving thousands of mortgage loans, alleging similar violations and seeking the remedy of rescission. In reaction to these lawsuits, the 1995 Amendments clarified the treatment of several fees typically associated with real-estate lending, and asked the Board to study ways to improve the finance charge.

[9] The Board solicited comment in December 1995 (60 Fed. Reg. 66,179 (1995). It received about 200 comments relating to possible changes to the finance charge; nearly 80 percent of the comments were from financial institutions, mortgage creditors, other creditors, service providers, and their trade associations. Seven comments were received from consumer groups.

[10] Board of Governors of the Federal Reserve System, Finance Charges for Consumer Credit under the Truth in Lending Act. April 1996 (Board of Governors, 1996).

Many mortgage loan creditors, however, made a more fundamental argument. They asserted that the APR is flawed and that broader reform is needed. They reported that, in their experience, most consumers do not understand the APR or use it for shopping. They said that consumers seeking home-secured credit would prefer to be told the interest rate, the dollar costs needed to close a loan, and the monthly payment. Consumer advocates stated that the APR concept is worthwhile but that the many exclusions from the finance charge reduce the value of the APR as a price tag for home-secured credit shopping. The preliminary report indicated further study of this issue was needed; the present report concludes the Board's study.

In the Congress's mandate to study TILA's finance charge, the Board was also asked to address any abusive refinancing practices that creditors may use to avoid TILA's three-day right of rescission for certain transactions secured by the borrower's home.[11] The Board concluded that anecdotal evidence suggested such practices were limited and could be addressed under existing law.[12] In addition, rescission and advertising issues were addressed

[11] TILA allows consumers to cancel (or rescind) certain credit transactions secured by the consumer's home, including refinancings. The typical rescission period is three days after loan closing; generally, loan proceeds may not be disbursed during this period. If the creditor refinancing the loan is the same creditor that initially extended the credit, a consumer may rescind the refinancing only to the extent new monies are advanced. If the consumer refinances a loan with a new creditor, the entire transaction is rescindable, whether or not new monies are advanced.

[12] Many commenters reported being unaware of any abusive refinancing practices by creditors. Representatives of government agencies and consumer advocates did point to certain practices. They asserted that some creditors or settlement agents ask consumers to sign an "Election Not to Rescind" form at closing--in violation of the rules requiring a three-day wait. Consumer advocates also identified practices involving high closing costs in refinancings that escape the law's protection because the loan is with the same creditor and no "new money" is advanced. Some commenters discussed "loan-splitting," where a consumer enters into an unsecured loan for a small amount of money, but pays closing costs (such as broker's fees) usually associated with a home-secured loan. Soon after the unsecured loan is made, the creditor "refinances" the unsecured loan and takes a security interest in the consumer's home. Rescinding the new transaction entitles the consumer to a refund of all fees paid in connection with the secured credit -- including fees paid to third parties such as brokers. In this case, however, the broker's fees were part of the unsecured loan, and are not refundable.

in 1995,[13] and the Board reviewed in 1996 TILA's disclosure rules for home-equity lines of credit.[14]

4. Consumer Surveys and Focus Groups. In February and March 1997, the Board commissioned a study, through the University of Michigan's Survey Research Center's Survey of Consumers, to gain insight into information consumers use to shop for credit, and on consumers' understanding of the APR.[15]

Many consumers claimed to shop at least a moderate amount when applying for a home purchase mortgage. Consumers typically contacted a few creditors, although over 20 percent of those surveyed contacted only one creditor. Generally, consumers shopped based on dollar figures, such as amounts needed to close the loan (points, application fees, and origination fees) and the monthly payment amount. The data showed that nearly all of

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[13] Both the rescission and the advertising studies were mandated by the Riegle Community Development and Regulatory Improvement Act of 1994, 12 U.S.C. § 4701. Section 344 directed the Board to analyze whether consumers would benefit from having greater flexibility in waiving the three-day right of rescission when no additional debt is incurred in a refinancing or consolidation of home-secured loans. Both creditors and consumers have complained that the three-day wait was unnecessary and not always to consumers' benefit. The Board's report supported increased flexibility given the limited circumstance. Board of Governors of the Federal Reserve System, Consumer Waivers of the Right of Rescission under the Truth in Lending Act, March 1995 (Board of Governors, 1995). Section 336(b) directed the Board to analyze the ways existing credit advertising rules could be modified so as to increase consumer benefits and decrease creditor costs and to ease rules for radio advertisements without diminishing consumer protection. The Board's report recommended the elimination of a few specific advertising requirements. The report also recommended greater consistency among the advertising rules, which currently differ depending on the type of credit being offered, and abbreviated requirements for radio advertisements. Board of Governors of the Federal Reserve System, Consumer Credit Advertising under the Truth in Lending Act, September 1995 (Board of Governors, 1995).

[14] Board of Governors of the Federal Reserve System, Rules on Home-Equity Credit under the Truth in Lending Act, November 1996 (Board of Governors, 1996). The study was prompted by the congressional hearings that preceded enactment of HOEPA, which covers closed-end loans. Testimony at the hearings suggested that abusive lending practices were not connected with open-end home-equity lending. Although the Congress exempted open-end credit from HOEPA, it directed the Board to study the adequacy of TILA's rules in protecting consumers seeking such credit. 15 U.S.C. § 1605 note (Supp. II 1996)(Ensuring That Finance Charges Reflect Cost of Credit). The Board concluded that the existing law's comprehensive disclosures and substantive limits provide adequate protections. The report on home-equity lines of credit included suggestions for improving the effectiveness of TILA disclosures, such as by streamlining the number of disclosures given at application and modifying the disclosure format to highlight key disclosures in a more meaningful sequence. The report also suggests conforming certain disclosures for open-end and closed-end variable-rate loans. In 1996, the Congress amended TILA to give creditors offering closed-end variable-rate mortgage loans the option of disclosing information about the maximum payment in lieu of presenting a historical table showing how the interest rate and the required payment would have been affected during the preceding fifteen-year period. The Congress did not provide a similar option for open-end home-secured plans.

[15] A preliminary analysis of the data concerning closed-end real-estate-secured loans was presented at the July 1997 public forum. Jeanne M. Hogarth, Jinkook Lee, and Doug M. Conover, "Consumer Shopping for Home Purchase Mortgages: Evidence from Consumer Surveys," Working Paper (Division of Consumer and Community Affairs, Federal Reserve Board 1997).

the respondents shopped on interest rates, and that most of them do not understand the relation between the contract interest rate and the APR.

In February 1998, the Board commissioned consultants to conduct four focus groups consisting of potential and experienced home buyers. Each group discussed the process of shopping for a mortgage loan, and the content and reliability of disclosures received in real-estate-secured transactions. They named the interest rate, closing costs, type of loan (e.g., fixed or variable) and points as the most important information consumers need when shopping for a mortgage loan.

Overall, most consumers believed that although the current TILA and RESPA disclosures are useful in shopping in a mortgage loan, they could be improved. When asked how, focus group participants suggested the use of "consumer-friendly" terms, better explanations of terms, and highlighting other important shopping information--namely, the interest rate, points, and monthly payments.[16] Generally, consumers found the closing costs itemization in RESPA's GFE more beneficial for shopping, although they believed the cost disclosures highlighted under TILA--the APR, finance charge, amount financed, and total of payments--also contain helpful information.[17] When shopping, consumers were more concerned about the amount required to close the loan; however, they also wanted the TILA disclosures that show the overall cost of the credit.

Consumers were concerned about the reliability of cost disclosures--the GFE, in particular. Some participants were dissatisfied with the "surprise" they experienced at closing when the final costs were significantly higher than those listed on the GFE. Others expressed satisfaction with the reliability of the numbers and believed in their ability to choose a creditor that would provide accurate numbers.

5. ***Consumer Advisory Council***. At several of its meetings in recent years, the Board's Consumer Advisory Council has considered efforts to reform and simplify TILA and RESPA.[18] In 1995, a task force of Council members considered ways in which the mortgage loan process, specifically the disclosures required under TILA and RESPA, could be simplified. In 1996, the task force presented to the Council a report that recommended,

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[16] The focus groups were presented with a sample disclosure form combining the TILA and RESPA disclosures.

[17] Unfortunately, their belief was based on misconceptions about what the disclosures represent. For example, consumers believed the APR represents the interest rate (it expresses the dollar cost of credit as an annualized rate and often includes more than interest), and the amount financed represents the note amount (it is the amount of funds actually made available to the consumer and is often less than the note amount).

[18] The Council is composed of thirty individuals representing creditors, consumer groups, state agencies, and other constituencies affected by the Board's consumer responsibilities.

among other specific ideas, a single federal disclosure with simplified text and an educational piece designed to reduce consumers' confusion and anxiety about the mortgage loan process.[19]

Throughout 1997, the Council further considered possible improvements to TILA and RESPA, reaffirming that disclosures should be simplified. Views were divided on possible changes to the finance charge and the APR: Some members believe that the finance charge and the APR are helpful shopping tools that should be retained; others believe that consumers neither understand nor use the APR and that the concept should be abandoned in favor of disclosures highlighting the interest rate, monthly payments, and costs to close the loan. The Council also consulted with the Board about the home-equity loan hearings. Council members representing creditors expressed concern about compliance issues such as the complexity of the dollar-based trigger for HOEPA coverage and the lack of explicit rules for correcting errors. Consumer representatives called for additional measures to curb abusive practices, such as "flipping" (where loans are refinanced repeatedly).

6. Congressional Oversight. In July 1997, joint hearings on TILA and RESPA reform were held by two Subcommittees of the Senate Committee on Banking, Housing, and Urban Development (Financial Institutions and Regulatory Relief, and Housing Opportunity and Community Development). Members urged the agencies, consumer groups, and various participants in the mortgage origination industry to work together in developing legislative recommendations to streamline the statutes. Since then, the Board and HUD have met many times with congressional staff concerning the ongoing efforts for reform.

7. Private Sector Initiatives. Independently of the agencies' activities, representatives of consumer groups and the industries affected by the mortgage lending process joined together in 1997 to form the Mortgage Reform Working Group (Working Group). Its goal is to explore the issues raised by fundamental TILA and RESPA reform and to recommend initiatives based on consensus resulting from the Working Group's deliberations. In December 1997 the Board hosted a series of meetings with HUD and representatives of the Working Group, and in 1998 the agencies attended several of the group's sessions. The Board and HUD also have met several dozen times with member organizations of the Working Group.

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[19] Importantly, the task force also noted that even though the "stack" of papers associated with closing mortgage loans frustrates consumers and creditors alike, only four documents were required by TILA and RESPA: TILA's cost disclosures and RESPA's settlement statement, transfer of servicing statement, and escrow statement. It is a common misperception that the massive amount of documentation provided at closing is attributable to TILA and RESPA requirements.

Characterization of Costs as Finance Charges under Required-cost Test[1]

	Current TILA	Required-cost test
Loan origination fee	√	√
Loan discount	√	√
Per diem interest	√	√
Mortgage broker fee paid by borrower	√	√
Application fee	-	√
Annual fee for open-end plan	N	√
Real estate commission	N	N
Credit report	N	√
Appraisal/survey	N	√
Lender's inspection fee (pre-consummation)	N	√
Pest inspection	N	√
Tax/flood certification	N	√
Tax/flood service (life of loan)	√	√
Assumption fee (pre-consummation)	√	√
Document preparation (loan-related)	N	√
Document preparation (deed)	N	N
VA application fee	√	√
Mortgage insurance premium	√	√
Hazard insurance premium	N	N (special exception)
Credit life/disability insurance (optional)	N	N
Credit life/disability insurance (required)	√	√

[1] All approaches exclude from the finance charge costs payable in a comparable cash transaction. The legend for the table is:
√ = treated as a finance charge under this approach
N = excluded from the finance charge under this approach
\- = treatment depends on circumstances

	Current TILA	Required-cost test
Reserves to be Deposited with Lender		
City/county property taxes	N	N
Title Charges		
Settlement or closing fee	-	√
Abstract or title search/title examination	N	√
Title insurance/binder - lender's coverage	N	√
Title insurance - owner's coverage	N	N
Notary fees (for mortgage)	N	√
Attorney's fees (consumer)	N	N
Attorney's fees (lender)	-	√
Government Recording and Transfer Charges		
Recording fees: mortgage, release	N	√
State/city/county tax/stamps: mortgage	N	√
Recording fees: deed	N	N
State/city/county tax/stamps: deed	N	N
Transfer tax	N	N
Miscellaneous Fees		
Amortization schedule (optional)	N	N
Courier fees - settlement agent	-	-
Lock-in fee	√	√
Late payment charges	N	N
Escrow for required repairs	N	N

Issues Concerning the Home Ownership Equity and Protection Act of 1994

In June 1997, the Board held hearings on the home-equity market, and on the effectiveness of the Truth in Lending Act (TILA), including the Home Ownership and Equity Protection Act of 1994 (HOEPA), in protecting the rights of consumers, particularly low- and moderate-income consumers. HOEPA applies to certain home-secured loans with rates or fees above a certain amount.[1] HOEPA layers disclosure and timing requirements onto the requirements already imposed under TILA for closed-end mortgage loans. It also imposes contractual limitations on creditors offering HOEPA-covered loans. This report discusses the content of HOEPA disclosures in chapter 2, the timing of disclosures in chapter 4, and substantive protections and enforcement in chapter 6. Issues raised at the hearings concerning coverage, liability concerns, exemptions, and rulewriting authority are summarized below.

A. *Coverage*

*1. **Open-end Home-secured Transactions.*** HOEPA's "high-cost mortgage" provisions do not apply to all home-secured credit transactions. For example, home-purchase loans are exempt. Reverse mortgages are also exempt (but are subject to an alternative detailed disclosure scheme).[2]

Open-end lines of credit are also exempt from HOEPA's "high-cost mortgage" provisions. However, at the same time it enacted HOEPA, the Congress asked the Board to study whether the existing TILA rules provide adequate protections for consumers obtaining home-equity lines of credit. In November 1996, the Board reported to the Congress that adequate protections exist and that there was no evidence at that time to support the belief that excluding lines of credit from HOEPA encourages creditors to offer open-end home-

[1] The rate-based test for a HOEPA-covered loan is met if the APR at the time of consummation exceeds by more than 10 percentage points the yield on Treasury securities having a comparable maturity. The dollar-based test is met if the total points and fees exceed 8 percent of the loan amount or a certain dollar amount, whichever is greater. The dollar figure is adjusted annually; for 1998 it is $435.

[2] A reverse mortgage transaction is a loan secured by the equity in a home where the balance increases rather than decreases over time. Disbursements are made to homeowners--typically on a monthly basis and to the elderly--until the homeowner dies, moves permanently, or sells the home. A part of HOEPA established a new calculation under TILA to measure the cost of reverse mortgage credit. Creditors must disclose the projected total cost of the credit, expressed as a rate (the "total annual loan cost" rate, or "TALC"). Unlike the APR, which is based solely on costs characterized as finance charges, the TALC rate takes account of any equity or shared appreciation that the homeowner will owe the creditor contractually and all charges and costs, including the cost of an annuity the consumer purchases (if any). The reverse mortgage disclosures are a layer on other disclosure requirements under TILA, and creditors must disclose an APR in addition to providing TALC rates for the reverse mortgage disclosure. TILA currently requires creditors offering reverse mortgages to provide cost disclosures at least three days before loan consummation.

equity lines as a way of evading the act's stricter disclosure rules and limitations for closed-end home-equity loans.[3]

Views expressed at the 1997 public hearings and in written comments were mixed on whether HOEPA should continue to exclude from its coverage home-secured, open-end lines of credit. A primary characteristic of open-end (revolving) credit is that creditors contemplate consumers may borrow to the extent they repay existing debt. Consumer representatives were uniformly concerned about creditors that incorporate into their loan agreements terms that satisfy the TILA's tests for open-end credit, but administer the loan as closed-end credit. Consumer representatives reported seeing some, but not a great many, of these agreements. They believed it would be appropriate to extend the HOEPA's coverage to open-end loans. Some creditors making HOEPA-covered loans agreed; they saw no reason to distinguish between revolving and installment credit. Other creditors, however, believed additional regulation was unnecessary.

Anecdotal evidence suggests that some creditors may be refinancing home-secured installment credit with open-end credit lines; this is troubling, even if it is not widespread. There is merit to the argument that consumers entering into high-priced home-equity credit lines should receive the same protections as those entering into a HOEPA-covered installment loan. However, as a general matter, the Board does not favor additional regulation where adequate protections exists. On balance, it seems premature to recommend extending HOEPA coverage to open-end credit.[4]

2. ***Fees-based Test.*** There is general consensus that HOEPA's fees-based test is complicated. HOEPA covers loans if the total fees payable by the consumer at or before loan closing exceed the greater of a set dollar amount or 8 percent of the loan amount. (The dollar figure is CPI-adjusted annually; for 1998, it is $435.) Fees included in the calculation include all compensation paid by consumers to brokers, "finance charges" (other than interest) such as points or origination fees, and closing costs such as appraisals that are paid to the creditor or the creditor's affiliate. Complaints were raised at the hearings about each component.

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[3] Board of Governors of the Federal Reserve System, <u>Rules on Home-Equity Credit under the Truth in Lending Act, November 1996</u> (Board of Governors, 1996). *See* Board of Governors of the Federal Reserve System, *supra* note 13, at app. B.

[4] If the Congress determines that HOEPA coverage should be extended to open-end home-secured plans, the rate- and fees-based tests should be modified for these loans. For example, the rate-based test for closed-end mortgages is based on an APR that includes interest and other fees such as discount points and origination fees; the APR for open-end plans includes interest only. Also, the fees-based test is currently triggered by the amount of fees in relation to the "loan amount;" under an open-end plan, the amount of credit actually obtained is unknown at the time the account is opened.

Consumer representatives believe the fees-based test should include broker compensation paid by the creditor to the broker because consumers fund the payment through increased points or interest rates. Creditors, on the other hand, believe that broker costs paid indirectly by the consumer are captured by HOEPA's tests.

Broker representatives expressed concern about complying with the affiliate-closing cost component. One representative explained the complexity of the rule that requires brokers to know what affiliated business relationships the potential creditor may have as well as which fees that creditor or its affiliate will retain.

The largest source of compliance frustration in calculating the fees-based test, however, touches both the closing cost and "finance charge" components. As discussed in chapter 2, most closing costs associated with real estate-secured loans are excluded from TILA's finance charge. National creditors noted that fees vary in their service and name; the diversity makes it difficult for lenders to determine with certainty whether a fee is properly characterized as a finance charge and included in the fees-based test, or a closing cost that may be excluded.

There was broad agreement that HOEPA's fees-based test should be simplified, for example, by including all costs paid by the consumer at closing, irrespective of their characterization for other purposes under TILA. However, creditors and consumer representatives disagree whether "all costs" should include optional credit life insurance purchased by the consumer and the extent to which an all-cost approach merits a corresponding increase in the current 8 percent trigger, if any.[5]

Calculating the fee-based trigger is one of creditors' greatest compliance concerns under HOEPA. The rule appears straightforward--the loan is covered if closing costs exceed the greater of 8 percentage points of the loan amount or $435 (in 1998). However, the calculation is complex. TILA's "some fees in, some fees out" approach to characterizing fees as finance charges is part of the problem. The calculation becomes more complicated for brokers that submit loan applications to several creditors and must determine whether certain closing costs will be paid to the creditor or affiliate (included in the fees-based test) or to an unaffiliated third party (excluded from the test).

Modifying the TILA's finance charge would simplify HOEPA's fees-based test. Alternatively, the fees-based test could be simplified to include all costs paid at closing,

[5] Creditors oppose including the premiums for optional credit life insurance in the fees test, believing the choice to purchase insurance is a separate decision made by the consumer. However, consumer representatives champion the inclusion of credit life premiums in the fees test. They argue that HOEPA-loan recipients often do not understand that the loan could be funded without purchasing credit insurance. More fundamentally, they believe the premium is a cost payable at closing and should be included.

without regard to whether the fee is a finance charge or paid to the creditor (or its affiliate) or an unaffiliated third party. If the Congress simplifies the fees-based test by adding more or all closing costs (including changing TILA's finance charge definition), the number of HOEPA-covered loans could increase; the Congress may wish to consider whether it would be appropriate to adjust the 8 percentage point and fee trigger.

B. Liability Concerns

Failure to comply with HOEPA may result in significant losses to the creditor and subsequent purchasers of the loan. Consumers entering into a HOEPA-covered loan may rescind the transaction for up to three years after closing if creditors fail to provide the special HOEPA disclosures or if they include a prohibited term in the loan agreement. Creditors--and any subsequent assignee--face civil money penalties equal to all finance charges and fees paid by the consumer.

1. Correcting Errors. Creditors are concerned about the lack of clear guidance in TILA about how to correct, after the loan is consummated, an error made in connection with a HOEPA disclosure. For example, a creditor may learn in a post-consummation audit that the rate or fees charged for the loan were high enough to trigger HOEPA rules, and that HOEPA disclosures should have been provided. Although TILA addresses actions creditors may take when they discover an error in a disclosure being provided at the loan closing, creditors are concerned that a court might determine that this provision is inadequate for curing a HOEPA disclosure violation when the creditor cannot go back in time (in the case of a disclosure that had to be given before closing). Investors holding large portfolios of HOEPA loans are concerned about exposure to loss and whether errors in HOEPA disclosures discovered after closing can be cured.

The Board believes that a procedure for lenders to correct HOEPA disclosure errors discovered after consummation should be considered. The process could be similar to TILA's current provisions, permitting creditors to provide an accurate version of the disclosures and allowing consumers an additional period to rescind the transaction.

2. Assignee Liability. Consumer representatives applaud HOEPA's extension of liability to subsequent purchasers and believe it to be a necessary curb against abusive lending practices. Creditors believe the additional liability has a chilling effect on creditors and investors alike, neither wanting the potential exposure for liability. Creditors advocate eliminating assignee liability altogether.

The Board is not recommending that HOEPA's assignee liability provisions be eliminated. Testimony indicates that while the provisions may have a chilling effect on some creditors and investors, the capital markets and other investors are willing to assume the risk associated with HOEPA-covered loans in securitization and other loan-purchase programs.

These provisions encourage those funding HOEPA-covered loans to monitor the practices of those closing the loan; evidence of continuing abuses despite these safeguards suggests the assignee provisions should remain.

C. Exemptions

HOEPA authorizes the Board to exempt specific mortgage products or categories of mortgages from some or all of HOEPA's prohibitions. Many of those testifying at the Board's hearings believed no exemptions were appropriate at this time. Others offered a variety of possible exemptions ranging from certain mortgage products (first lien loans) to particular creditors (small investors who are less likely to understand TILA's complex disclosure requirements). One creditor suggested exemptions for loans not the target of HOEPA such as if a consumer's debt-to-income ratio is below a certain percentage, such as 50 percent. The Board is not recommending any exemptions to HOEPA at this time, based on the comments received and its own analysis.

D. General Rulewriting Authority

HOEPA removes the Board's general rulewriting authority in implementing HOEPA. Many creditors believe that limitation should be eliminated. They believe that some compliance burdens under the statute could be reduced through the Board's authority to make classifications or create exceptions to facilitate compliance without diminishing consumer protections. The Congress may wish to reconsider its limitation on the Board's rulewriting authority for HOEPA-covered transactions. For example, chapter 2 of this report discusses possible improvements to the content of HOEPA's disclosures, based on comments and testimony received in connection with the Board's hearings: Greater flexibility through rulemaking and public comment could result in model clauses with more user-friendly messages for the text of "warnings" than is currently prescribed by the statute.

The Board's Economic Analysis of "Packaging:" Potential Market Structure and Performance Implications of Guaranteeing Closing Costs

While it is difficult to make firm predictions, it is plausible that given a choice between estimating or guaranteeing closing costs, many creditors will choose to guarantee them. To provide a reliable basis for the guarantee, these banks may enter into vertical relationships with ancillary service providers (assuming that § 8 of RESPA restrictions on the fees associated with such relationships are eased.)[1] Creditors may choose to guarantee costs in conjunction with entering into vertical relationships because they believe that they can thus achieve cost savings for their customers, because such relationships may reduce total transaction costs and consumer search costs.[2] Another reason that creditors may choose to guarantee costs is that they believe it will provide marketing advantages.

1. Implications of Vertical Relationships for Competition. If significant economies of scale are associated with vertical relationships, smaller creditors or ancillary service providers may find competing with larger creditors difficult. In the presence of economies of scale, larger creditors may benefit from volume discounts provided by ancillary service providers, and larger ancillary service firms may benefit from reduced transactions costs resulting from bulk contractual arrangements. Even in such cases, however, smaller creditors and ancillary service providers may be able to form alliances that would enable them to achieve economies of scale and remain competitive. For example, small creditors may be able to contract jointly with a title insurance company to achieve volume discounts. Moreover, in smaller markets or in particular market niches, volume discounts may be unavailable because of the small number of total transactions, and smaller creditors would remain competitive. Thus, it is by no means clear that smaller creditors or ancillary service providers would, in general, be disadvantaged by removing restrictions on creditors' ability to form vertical relationships with ancillary service providers.

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[1] In a vertical relationship the creditor acts as an intermediary, purchasing the services from affiliated or unaffiliated providers for resale to consumers as part of a loan origination package. Instead of entering into vertical relationships with ancillary service providers, a creditor may base its guarantee on prices observed in previous transactions; however, doing so may not provide as reliable a basis for guaranteeing closing costs.

[2] For particular items within the package, however, for the bank to serve as an intermediary may be less efficient than for the consumer to transact directly with the ancillary service provider. For example, interacting directly with title insurance providers may be more efficient, particularly because title insurance services are now offered over the Internet, giving consumers low-cost access to a wide range of choices.

A creditor might not permit borrowers to choose another provider for a service that the creditor has incorporated into a loan origination package. Economic theory suggests that tying arrangements where the creditor requires the use of affiliated providers, raise potential anti-competitive issues, in that tying may allow a creditor with monopoly power in one line of business to create or retain a monopoly in a second line of business.[3] Thus, for example, in a town with only one mortgage creditor, a creditor requirement that title insurance be purchased from an affiliated provider might drive competing title insurance companies out of business. However, such a result would require prior monopoly power on the part of the institution. It would also require that the attempt to expand monopoly power would not induce other creditors to enter the market. Most local mortgage markets are highly competitive, and barriers to entry into local mortgage markets are low because of the existence of many, large creditors who operate on a nationwide scale.[4] Rapid advances in information and computer technology also help to ensure competitive local markets. Hence, even in concentrated markets, attempts to exploit and expand market power are apt to invite entry and, as a result, not succeed. Thus, in general, there is little reason to expect anti-competitive effects from tying arrangements.[5]

2. ***Potential Conflicts of Interest Associated with Vertical Relationships***. Vertical relationships between creditors and providers of pest inspection, property inspection, and perhaps other services may entail conflicts of interest that adversely affect borrowers. For instance, the degree to which a pest inspection company "errs" in the direction of finding infestations may be of little concern to the creditor but can result in significant costs for borrowers. A lending institution may maintain an exclusive arrangement with a pest control company (requiring all borrowers to use that company) because the company offers low-cost inspections even if the company is prone to making such errors. Similarly, the amount of time a property inspector spends on detecting and reporting minor flaws

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[3] *See* Jean Tirole, Theory of Industrial Organization (1989).

[4] *See, e.g.*, Norwest Corporation, 82 Federal Reserve Bulletin 621, 683 (1996).

[5] Some industry representatives have argued that mortgage brokers will be unable to compete with direct creditors if creditors form affiliations with appraisers. Mortgage brokers typically obtain a single appraisal for a given loan application and then offer the application to several creditors. Doing so would not be possible if creditors only accepted appraisals by their affiliates.

There is little reason to believe, however, that the services of mortgage brokers would become extraneous if creditors and appraisers were allowed to form affiliate relationships. To the extent that the services of brokers remain valuable to creditors and consumers, creditors would not want to forgo these services and would be willing to accept independent appraisals in conjunction with brokered applications.

that have no bearing on the creditor's risk exposure would be of little concern to the creditor but might be a significant issue for the borrower.[6]

*3. **Pricing Implications***. To guarantee costs, creditors may need to rely on average-cost pricing of settlement services, where prices might otherwise vary with particular situations. For example, currently, in the absence of guarantees, prices charged by title companies typically vary with the complexity of the search.[7] To provide a standard quote for closing costs in order to guarantee the price, a creditor may contract with a title service provider to obtain creditor's title insurance at a fixed price that would reflect the average cost of a title search. In such cases, lower-cost customers would cross-subsidize higher-cost customers. This effect of guarantees would be mitigated to the extent that creditors develop product-specific guarantees.

Further, creditors that guarantee costs may have to allow some margin in case they have to absorb a cost increase before closing. Passing on the cost of the risk may result in higher guaranteed prices, although the marginal effect may be small in many cases.

On the one hand, these pricing consequences could diminish any advantage of guaranteeing costs and could prompt creditors to estimate costs. On the other hand, as noted, vertical relationships between creditors and ancillary service providers could result in lower transactions costs. Lower transactions costs might then lead to lower consumer prices for ancillary services.

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[6] Because of potential conflicts of interest, certain services could remain subject to restrictions under § 8 of RESPA.

[7] For instance, many companies offer discounted "reissue rates" for searches on properties that they had conducted searches on in the recent past.

HUD's Proposal Applicable to Mortgage Brokers

Under HUD's current RESPA regulations, mortgage brokers using table funding must disclose on the GFE and the HUD-1 or HUD-1A all fees, whether paid by borrowers or wholesale creditors, in connection with settlement.

In recent years, lawsuits have been brought based in whole or in part on the theory that certain fees paid to mortgage brokers by creditors are fees for the referral of business in violation of § 8 of RESPA. Courts have reached differing conclusions. One district court held initially that such fees were illegal. Two other Federal district courts initially concluded that yield spread premiums (or differentials) were not per se violations of RESPA and therefore refused to certify class actions on this issue. (Following the issuance of HUD's proposed rule (see below) the U.S. Court of Appeals for the Eleventh Circuit held that, under the particular facts in that case, the yield spread premium paid by the creditor to the mortgage broker constituted an illegal referral fee under RESPA. A subsequent decision by the Circuit indicated that the holding of the case was highly dependent upon its facts, and that under other circumstances, yield spread premium payments could be lawful.)[1]

On October 16, 1997, HUD issued a proposed rule under RESPA that would establish a new disclosure to consumers.[2] This disclosure would be in the form of a contract between a mortgage broker and a consumer. Under HUD's proposal, the contract would disclose the functions of mortgage brokers including: the services the broker offered to provide, the broker's duties to the consumer and how the broker's compensation is derived, as well as the fees to the broker including the maximum amount of compensation the broker will earn in the transaction. HUD proposed a binding mortgage broker contract rather than a simple disclosure, because a binding contract creates an enforceable remedy for the consumer and ensures that the terms indicated cannot be changed or superseded unilaterally by the mortgage broker.

Under HUD's proposal, when a broker enters into the contract prescribed under the rule, and meets other criteria designed to protect the consumer, the direct fees paid by the borrower and the indirect fees paid to the broker by the creditor in the transaction would be presumed to be legal and permissible under § 8 of RESPA. The presumption of permissibility and legality will not apply, however, if one or more of the requirements is not met. Moreover, even if all of the requirements are met, the presumption may be rebutted if the total compensation received by the broker exceeds a test to be established by HUD during the rulemaking. Where the broker does not enter into a contract the fees may be presumed to be illegal.

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[1] Culpepper v. Inland Mortgage Corp., 132 F. 3d 692 (11th Cir.), *reh'g denied en banc*, 1998 WL 326627 (11th Cir. 1998).

[2] 62 Fed. Reg. 53,912 (October 16, 1997).

HUD believes that reform proposals regarding mortgage brokers should be as protective of consumer's interests as the proposed rule. The proposed disclosure would therefore still be appropriate under the estimated cost approach. Under the guaranteed cost scheme, however, where no specific amount of fees is disclosed, a statement of the mortgage broker's functions could suffice depending on the outcome of the reform process.

A copy of HUD's proposed mortgage broker disclosure contract follows. (Modifications to this disclosure for the guaranteed cost scheme could be made as appropriate.)

U.S. Department of Housing and Urban Development

Mortgage Broker Contract

otice to Prospective Borrower(s): Read this contract carefully so that you make an informed choice. You are entitled to a copy of this contract. Signing this contract does not obligate you to obtain a mortgage loan through this mortgage broker, nor does it constitute mortgage loan approval.

This contract is between:

Name(s) of borrower(s): ____________________, the "Borrower(s)" or "you"

and

Name of mortgage broker company: ____________________, located at

Address of mortgage broker company: ____________________, who has authorized

Name of mortgage broker: ____________________ to enter into this

contract on its behalf. In this contract, the mortgage broker company and the mortgage broker are called "I" and the entity which will provide your mortgage loan funds is called "lender."

Who Do I Represent?

__ **I represent you.** I am your agent and I will get you the most favorable mortgage loan that meets your stated objectives. I will shop for your loan from among ____ lender(s). I will charge you a fee for my services but I will not receive any fee for your mortgage loan from a lender.

__ **I represent you, but I may receive a fee from a lender.** I am your agent and I will get you the most favorable mortgage loan that meets your objectives. I will shop for your loan from among ____ lender(s). I may charge you a fee for my services and I may also receive an additional fee for your mortgage from a lender.

__ **I do not represent you.** I am not your agent. I arrange loans from lenders and get paid by lenders and borrowers. I make mortgage loans available from

__ one lender (name of lender) ____________________; or

__ among (number) ____ lenders.

What Will I Be Paid?

For arranging your loan of up to $ ________ at an interest rate of ________ (% rate or reference/attach ARM program), I will receive no greater than ________ points and other compensation of $ ________, so that my total compensation will be no greater than: ________ (total compensation in $ amount and/or % of loan).

My **Total Compensation** will be made up of: ________ plus ________

Fees **You Pay** me (\$ amount and/or % of loan) | Fees a **Lender Pays** me (\$ amount and/or % of loan)

If you would rather pay a lower interest rate, you may pay higher upfront fees; if you pay less up front, you may pay a higher interest rate. Before you sign this contract, I can display alternatives for you.

The amounts disclosed here apply only if you qualify for this loan.

We agree to the terms of this contract. By signing below, the mortgage broker further certifies that the information in this contract is accurate and complies with all provisions of section 8 of the Real Estate Settlement Procedures Act and 24 CFR part 3500.

Borrower(s) Signature & Date

Mortgage Broker Signature & Date:

X

Borrower(s) Signature & Date

Mortgage Broker License No: (where applicable)

X

Attention Borrowers: Know Your Rights!

This may be the largest and most important loan you get during your lifetime. You should be aware of certain rights before you enter into any loan agreement.

1. You have the RIGHT to shop for the best loan for you and compare the charges of different mortgage brokers and lenders.
2. You have the RIGHT to be informed about the total cost of your loan including the interest rate, points and other fees.
3. You have the RIGHT to ask for a Good Faith Estimate of all loan and settlement charges before you agree to the loan and pay any fees.
4. You have the RIGHT to know what fees are not refundable if you decide to cancel the loan agreement.
5. You have the RIGHT to ask your mortgage broker to explain exactly what the mortgage broker will do for you.
6. You have the RIGHT to know how much the mortgage broker is getting paid by you and the lender for your loan.
7. You have the RIGHT to ask questions about charges and loan terms that you do not understand.
8. You have the RIGHT to a credit decision that is not based on your race, color, religion, national origin, sex, marital status, age, or whether any income is from public assistance.
9. You have the RIGHT to know the reason if your loan was turned down.
10. You have the RIGHT to ask for the HUD settlement costs booklet "Buying Your Home."

Buying Your Home and other helpful information is available at HUD's WEB site:
http://www.hud.gov/fha/res/respa_hm.html

For other questions call 1-800-217-6970.