INTRODUCTION

In January 2007, the Senate Banking, Finance & Insurance Committee began a detailed examination of mortgage lending practices, and the laws and regulations that govern them. The Committee began by looking at nontraditional mortgage lending, and expanded into subprime mortgage lending, as California's and the nation's mortgage markets plunged into disarray.

Since this Committee's first informational hearing on nontraditional mortgage lending in January 2007, there have been widespread calls for improved mortgage underwriting, clearer and more helpful consumer mortgage loan disclosures, and more honesty and transparency in mortgage advertising. A myriad of bills on these topics have been introduced at both the state and federal levels, numerous legislative and Congressional hearings have been held, and several regulatory proposals have been advanced.

Although blame for the situation in which we now find ourselves has been has been cast upon virtually every mortgage market participant, Congress has been particularly hard on the Federal Reserve Board (FRB; the Board). Several members of Congress have singled out the FRB and other federal banking regulators for failing to act early enough to halt the lending practices that led to our current mortgage troubles. In partial response to these criticisms, the FRB has proposed several changes to the federal regulation (Regulation Z) that implements two of the nation's most broadly applied federal mortgage lending laws, the Truth in Lending Act (TILA), and the Homeownership Equity Protection Act (HOEPA).

If enacted, the proposed federal regulatory changes will apply to all mortgage lenders and loan originators, regardless of whether they are state- or federally-regulated. Some examples of those who are subject to Regulation Z, and who will be required to comply with any changes to the Regulation, include the following: national banks, state-chartered banks, federal thrifts, federal credit unions, state-chartered credit unions, state finance lenders, state residential mortgage lenders, and state mortgage brokers.

This hearing reviews the proposed changes to Regulation Z, with the goal of determining how these changes are likely to impact mortgage brokering and lending in California. This hearing is purposefully scheduled before the Board's 90-day public comment period ends, to give legislators who wish to comment on the proposal an opportunity to do so, using information they learn during the hearing.

BACKGROUND

On January 9, 2008, the Federal Reserve Board (FRB) published proposed modifications to Regulation Z (Federal Register, Vol. 72, No. 6, Wednesday, January 9, 2008, 1672-1735). Interested parties wishing to submit comments to the FRB on its proposal have 90 days (until April 8, 2008) in which to do so.

According to the FRB, the amendments to Regulation Z are intended to "protect consumers in the mortgage market from unfair, abusive, or deceptive lending and servicing practices, while preserving responsible lending and sustainable homeownership; ensure that advertisements for mortgage loans provide accurate and balanced information and do not contain misleading or deceptive representations; and provide consumers transaction-specific disclosures early enough to use while shopping for a mortgage." The proposed revisions have nine components, as follows:

- Four changes would apply to a newly-defined category of higher-priced mortgage loans secured by a consumer's principal dwelling.

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

- One set of changes would require mortgage advertisements to provide clear, accurate, and balanced information about mortgage interest rates, monthly payments, and other loan features, and would ban several deceptive or misleading advertising practices.

- One set of changes would require creditors to provide consumers with transaction-specific mortgage loan disclosures before the consumers pay any fee (other than a credit report review fee) related to their mortgage application.

Each of these proposed changes is described in more detail below, after a description of the two laws whose implementing regulation is being amended.

TILA

The Truth in Lending Act was enacted in 1968, to protect consumers in credit transactions. TILA applies to a broad range of consumer credit transactions. It requires clear disclosures of the terms and costs involved in various credit transactions, including those involving credit cards, home mortgages, and auto loans.

The TILA statute can be found at 15 USC Section 1601 et seq. Implementing regulations are contained in Regulation Z (12 CFR Part 226).

HOEPA

The Homeownership Equity Protection Act was enacted in 1994 in response to anecdotal evidence of abusive practices in the home equity lending market. HOEPA applies to closed-end home equity loans that have interest rates or fees above levels specified in law. HOEPA excludes open-end home equity lines of credit (HELOCs) and closed-end home purchase loans and reverse mortgage loans.

HOEPA is subset of the Truth in Lending Act. The HOEPA statute can be found at 15 USC 1639 et seq. Regulations implementing HOEPA can be found in Section 32 of Regulation Z (12 CFR Section 226.32)

ENFORCEMENT OF TILA AND HOEPA

Proposed changes to Regulation Z are best understood in the context of California's ability to enforce them.

Regulatory Enforcement

TILA and HOEPA authorize various agencies to enforce Regulation Z administratively. Federal banking agencies (including the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of Thrift Supervision, and National Credit Union Administration) may enforce the regulation against their bank, thrift, and credit union licensees. The Federal Trade Commission is generally authorized to enforce violations of Regulation Z involving any other entity or individual. State attorneys general may also enforce violations of regulations adopted under the authorization provided in TILA. However, neither HOEPA nor TILA grant state regulators specific authority to enforce these laws within California.

If California wants its regulatory agencies to apply specific provisions of HOEPA and/or TILA to state licensees, and to enforce those provisions against state licensees, state law would need to be amended to incorporate those provisions the state wished to enforce into state law. However, because several sections of state law are already more stringent than Regulation Z, the state need not act immediately if we wish to adopt all of the FRB's proposed changes. Representatives from the Department of Financial Institutions (DFI), Department of Corporations (DOC), and Department of Real Estate (DRE) will available during the hearing to discuss the extent to which the state laws and regulations they administer are already more stringent than Regulation Z, and the extent to which they believe their departments can enforce the proposed revisions to Regulation Z.

Civil Liability

TILA and HOEPA also authorize consumers to bring civil actions against creditors for actions that are unfair, deceptive, or abusive. Consumers who bring timely action against creditors under TILA's and HOEPA's authority can recover up to four types of damages: 1) actual damages, 2) statutory damages in an individual action of up to $2,000, or up to $500,000 or one percent of the creditor's net worth, whichever is less, in a class action; 3) special statutory damages equal to the sum of all finance charges and fees paid by the consumer; and 4) court costs and attorney's fees. Generally speaking, consumers have up to one year in which to bring civil action against a creditor for violations of TILA. Consumers have up to three years in which to bring civil action for violations of HOEPA.

Both laws treat assignee liability differently. TILA limits the liability of assignees for violations of Regulation Z to disclosure violations that are apparent on the face of the disclosure statement required by TILA. However, if a loan is a HOEPA loan, and if the creditor has assigned the loan to another person, a consumer can pursue damages from the assignee under a broader set of circumstances.

Neither law authorizes private civil actions against parties other than creditors and assignees. Generally speaking, for purposes of TILA, a creditor in the context of a mortgage loan transaction is the party to whom the debt is initially payable. A mortgage broker is not a creditor unless the debt is initially payable to the broker. A servicer is not considered to be an assignee under TILA if the servicer is or was the owner of the obligation only for purposes of administrative convenience in servicing the loan.

TILA fails to authorize private civil actions against parties who violate its advertising provisions. In contrast, HOEPA authorizes private civil actions for violations of all of its substantive provisions. Most of the Board's proposed rules relating to advertising disclosures would not create civil liability for violators, because the revisions are being promulgated under TILA. However, the Board's proposed prohibition of seven specific advertising acts and practices (discussed more fully below) is being promulgated under HOEPA and would therefore create civil liability for violators. Violators of any of the Board's proposed advertising provisions would also be subject to administrative enforcement by authorized regulators.

Right to Rescind

Under TILA, consumers have a right to rescind a mortgage loan transaction for up to three years after consummation, when that mortgage is found to violate a rule adopted under authority of TILA. Any consumer who has a right to rescind a transaction under TILA may also rescind that transaction against any assignee of the obligation. A consumer's right to rescission under TILA ends the three years after loan consummation or when the property is sold, whichever is earlier. Violations of substantive prohibitions of HOEPA constitute violations of TILA and also trigger three-year rescission rights against a creditor, or, if applicable, against an assignee.

According to the FRB, the only portion of its proposal that would be covered by the three-year right of rescission is the one involving prepayment penalties. According to the FRB, "other rules the Board is proposing would not be prohibitions of particular provisions of mortgages, and violations of those rules therefore would not trigger the extended right of rescission."

PROPOSED REVISIONS TO REGULATION Z

Protections Covering Higher-Priced Mortgage Loans

Four of the Board's proposals would apply to a new class of loans, called "higher-priced mortgage loans." Higher-priced mortgage loans would be defined as consumer-purpose, closed-end loans secured by a consumer's principal dwelling, with an annual percentage rate (APR) that exceeds a comparable Treasury security by three or more percentage points for first-lien loans and by five or more percentage points for second-lien loans. The definition includes home purchase loans, refinancings, and home equity loans, but excludes home equity lines of credit, reverse mortgages, construction-only loans, and bridge loans. Special rules are provided by the Board to determine what constitutes a "comparable Treasury security" for purposes of the proposal. The loan caps used to define higher-priced mortgage loans are expected to cover all subprime loans and the higher-priced end of the Alt-A loan market.

Proposal Number 1 Governing Higher-Priced Loans: Prohibit creditors from engaging in a pattern or practice of extending credit without regard to a borrower's ability to repay from sources other than the collateral itself.

HOEPA already prohibits the pattern or practice of extending loans based on consumers' collateral, without regard to their repayment ability. The Board's proposal would extend this prohibition to the new class of higher-priced loans created by the changes to Regulation Z. Creditors would be required to verify income using W-2s, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income and assets. They may evaluate a consumer's current and expected future income, but assumptions of expected income must be reasonable. The prohibition applies based on the facts and circumstances upon consummation of the loan, not those that occur afterwards (i.e., creditors would not be liable for extending credit to someone who later loses their job, as long as the creditor did not have knowledge that the job was about to be lost). When two different creditors are extending loans simultaneously to the same consumer, each creditor would be expected to verify the obligation the consumer is undertaking with the other creditor.

The Board is not proposing a specific debt-to-income ratio that would create the presumption of a violation, nor is it proposing a specific ratio that would provide a safe harbor. In recognition of the fact that most borrowers sell their homes or refinance within seven years, ability to repay would have to be considered during the first seven years of the loan, not over the entire life of the loan.   Assessment of a borrower's ability to repay would have to consider the loan payments, as well as the likely property taxes and homeowners insurance. The proposal would contain a safe harbor for creditors who fail to verify income before extending credit, if the amount of income or assets that were not verified were not materially greater than the creditor could have verified when the extension of credit was consummated (i.e., when a creditor's failure to verify income would not have altered the decision to extend credit).

In support of its proposed change, the Board notes that "in recent years, many subprime lenders did not consider adequately whether borrowers would be able to afford the higher payment, and appeared instead to assume that borrowers would be able to refinance notwithstanding their very limited equity." The Board also notes that borrowers, particularly those in the subprime market, will accept loans they will not be able to repay. "In some cases, less scrupulous originators may mislead borrowers into entering into unaffordable loans by understating the payment before closing and disclosing the true payment only at closing. At the closing table, many borrowers may not notice the disclosure of the payment or have time to consider it, or they may consider it but feel constrained to close the loan." Further, "in the subprime market in particular, consumers may accept loans knowing they may have difficulty affording the payments because they do not have reason to believe a more affordable loan would be available to them." And, "borrowers' own assessment of their prepayment ability may be influenced by their belief that a lender would not provide credit to a consumer who did not have the capacity to repay."

The Board is *not* proposing to prohibit making an individual loan without regard to repayment ability, but rather to prohibit a pattern or practice of doing so. The "pattern or practice" element is intended to balance potential costs and benefits of the rule. According to the Board, "creating civil liability for an originator that fails to assess repayment ability on any individual loan could inadvertently cause an unwarranted reduction in the availability of mortgage credit to consumers. The 'pattern or practice' element is intended to reduce that risk while helping prevent originators from making unaffordable loans on a scale that could cause consumers substantial injury."

The Board is not proposing to adopt a quantitative standard for determining the existence of a pattern or practice. It is, in essence, adopting a "we'll know it when we see it" standard.

<u>Proposal Number 2 Governing Higher-Priced Loans: Prohibit prepayment penalties on higher-priced loans unless all of the following conditions are met: a) the borrower's verified debt-to-income ratio at loan consummation is 50% or less, b) the term of the prepayment penalty is five years or less, c) the prepayment penalty expires at least sixty days before the first date, if any, on which the loan payment amount may increase under the terms of the loan, and d) the penalty is not prohibited under other applicable law. The proposal would also prohibit prepayment penalties if they are paid off using funds from a refinancing by the same creditor or its affiliate.</u>

HOEPA already prohibits prepayment penalties of the type that would be prohibited on higher-priced loans under the FRB's proposal. The proposal would simply extend the provisions of HOEPA to the broader class of higher-priced loans defined in the proposal. However, the FRB's proposal goes beyond HOEPA's existing prepayment penalty prohibitions by additionally prohibiting the imposition of a prepayment penalty within sixty days of the first date on which the loan payment amount may increase.

According to the Board, "the proposal is intended to prohibit prepayment penalties in cases where they may pose the greatest risk of injury to consumers. The 50% debt to income cap, while not a perfect measure of affordability, may tend to reduce the likelihood that an unaffordable loan will have a prepayment penalty, which would hinder a consumer's ability to exit the loan by refinancing the loan or selling the house. The same-creditor restriction may reduce the likelihood that a creditor could 'pack' a prepayment penalty into a loan as part of a strategy to strip the borrower's equity by flipping the loan in a short time. The five-year restriction would prevent creditors from 'trapping' consumers in a loan for an exceedingly long period. The mandatory expiration of the penalty before a possible payment increase would help prevent consumers who had been enticed by a discounted initial payment from being trapped when the payment increased." Home Mortgage Disclosure Act data for 2004 through 2006 suggest that a sixty-day period before a payment change would be enough time for a significant majority of subprime borrowers to shop for a refinancing.

Furthermore, citing a Federal Trade Commission study involving consumer testing, the Board concluded that existing disclosures regarding the existence of prepayment penalties are not adequate to ensure transparency. Prepayment penalties can prevent borrowers who cannot afford to pay the penalty from refinancing out of an unaffordable loan. Those who refinance and pay the penalty decrease their home equity and increase their loan balance if they finance the penalty into the new loan.

However, in offering its proposal, the Board was careful to acknowledge some of the benefits of prepayment penalties in certain circumstances. In principle, a lender may offer a consumer a choice between a loan with a prepayment penalty and a loan that does not have a prepayment penalty, but has a higher interest rate. For borrowers who know they will remain in a home for a period of time longer than the length of a prepayment penalty and who know they can afford their mortgage payments until their prepayment penalty period expires, a prepayment penalty may be one way to reduce one's costs at closing or one's monthly mortgage payments.

Prepayment penalties may also benefit subprime borrowers, by making bonds backed by subprime loans more attractive to investors, and thus increasing the amount of secondary market capital available to fund subprime loans. The Board notes that investors may find prepayment patterns more difficult to predict for subprime loans than for prime loans, because prepayment of subprime loans not only depends on interest rate changes (which also drive prime loan prepayment patterns), but also on changes in borrowers' credit profiles that affect their chances of qualifying for a lower-rate loan.

The FRB proposal is intended to preserve the potential benefits of penalties to consumers in cases where the penalties may pose less risk.

Under the terms of the proposal, a creditor would have to verify a borrower's debt-to-income ratio using third party documents. The proposed 60-day rule would be based on when the loan rate may increase, not when it actually does increase. As noted by the Board, "periodic payments may increase for a variety of reasons, including a scheduled shift from a discounted interest rate to a fully-indexed rate, a change in index value on a non-discounted ARM [adjustable rate mortgage], or mandatory amortization of principal when deferred principal or interest exceeds a certain threshold. For the sake of simplicity, the proposal would set a single standard for all higher-priced mortgage loans for which periodic payments may increase." The mandatory expiration would not be affected by a consumers' decision to pay more than their agreement requires. It would also be unaffected by a payment increase resulting from a borrower's late payment, default, or delinquency.

The Board is not proposing to require creditors to inform consumers when their prepayment penalty expires or is scheduled to expire. Under existing Regulation Z, an adjustment to the interest rate, with or without a corresponding adjustment to the payment in a variable-rate transaction, requires new disclosures to the consumer. These disclosures must be delivered to a consumer or placed in the mail at least 25 calendar days, but no more than 120 calendar days, before the new rate and payment amount apply. The Board believes that a notice which combines payment change information with information that one's prepayment penalty is about to expire could benefit consumers. However, the Board also recognizes that reconciling the current payment increase notice requirement with a notice that one's prepayment penalty period is about to expire could be difficult. For example, some creditors set a consumer's new payment or rate 30 or 45 days before the first possible change in the monthly payment – after the proposal would require a prepayment penalty period to end. Notification that one's prepayment period is about to expire might be more clear and conspicuous to a borrower if it were provided separately from the payment change notification. Allowing a combined notice might confuse borrowers by encouraging them to mistake a notice of their ability to refinance with a recommendation that they do so, and could encourage them to exit an otherwise affordable loan. In its proposal, the Board concludes this discussion by expressing its intention to defer drafting new disclosure requirements about the expiration of the prepayment penalty period until it proposes comprehensive amendments to Regulation Z's closed-end disclosure provisions.

<u>Proposal Number 3 Governing Higher-Priced Loans: Require the establishment of an escrow account for property taxes and homeowners insurance on first-lien loans. Allow borrowers to opt out of this requirement, but require them to wait a full year after loan consummation before doing so.</u>

The Board is proposing to make escrow accounts mandatory on first-lien higher-priced mortgage loans and to permit, but not require, creditors to offer borrowers an option to cancel escrows twelve months after loan consummation.

"The Board is concerned that the subprime market does not appear to offer borrowers a genuine opportunity to escrow…A collective action problem prevails if each individual [loan] originator fears that offering escrows would put it at a disadvantage relative to competitors, even if originators collectively would benefit from escrows. Each originator may fear losing business if it escrows. An originator that escrowed would have to quote a monthly payment that included taxes and insurance. Competitors that did not escrow could poach potential or actual customers of the originator by not including taxes and insurance in their quotes." The Board concludes that any single originator may be unwilling to escrow without assurance that its competitors will escrow, despite the fact that all originators would benefit if all of them escrowed (a situation known to economists as a collective action problem).

This market failure causes consumers substantial injury, by making it more likely that borrowers will take on mortgages they cannot afford, because they focus only on the principal and interest payment, and ignore other associated housing costs. Borrowers who face a tax or insurance bill they cannot afford are particularly vulnerable to predatory home equity loans.

The Board is proposing an opt-out rather than an opt-in, because an opt-in would allow some originators to discourage borrowers from escrowing, creating pressure on other originators to follow suit and leaving the collective action problem unresolved. Allowing consumers to opt out at closing or immediately thereafter would also be subject to manipulation. Some originators might still quote payments without taxes and insurance, and tell consumers that they could keep their payments from going up by signing a piece of paper at or shortly after closing. A fairly long period before allowing an opt-out is not only required to prevent possible manipulation by creditors, but also to educate borrowers about the benefits of escrowing.

In proposing to require escrows in certain cases, the Board also acknowledges that some state laws limit creditors' ability to require escrows and/or provide consumers with a right to cancel an escrow sooner than twelve months after closing. The Board notes that its proposal would pre-empt these state laws to the extent of an inconsistency.

Higher-Priced Loan Proposal 4: Prohibit evasion of the three afore-mentioned changes by structuring a loan as an open-end credit transaction.

In defining a higher-priced mortgage loan as a form of closed-end credit, the Board recognizes the potential for creditors to evade its proposed rules by structuring a loan as an open-end HELOC. For that reason, the Board is proposing to expressly prohibit a creditor from structuring a closed-end transaction as an open-ended one for purposes of evading proposed Regulation Z changes involving higher-priced loans.

In doing so, however, the Board notes that it is concerned about creating too broad an anti-evasion rule. It notes that consumers may prefer HELOCs to closed-end home equity loans, because of the added flexibility HELOCs provide them. The Board does not wish to limit consumers' ability to choose between the two ways of financing.

Protections Covering All Mortgage Loans

Proposal Number 1 Covering All Mortgage Loans: Prohibit creditors from paying mortgage brokers more than an amount the brokers disclose to consumers in advance as their total compensation. Require the broker and consumer to enter into an agreement about the broker's compensation before the consumer must pay a fee related to the mortgage application or before he or she submits the written application, whichever is earlier.

This proposal directly addresses a payment called yield spread premiums (YSPs). A YSP is defined as "the present dollar value of the difference between the lowest interest rate the wholesale lender would have accepted on a particular transaction and the interest rate the broker actually obtained for the lender." In other words, a YSP represents the difference between the higher interest rate a borrower agrees to pay and the lower interest rate the lender would have been willing to accept from the borrower. This dollar amount is usually paid to the mortgage broker, although it may be applied to other closing costs. The creditor's payment to the broker is an alternative to the borrower paying the broker directly from the consumer's pre-existing resources or from loan proceeds.

The Board proposes to prohibit a creditor from paying a mortgage broker in connection with a mortgage, unless the payment does not exceed an amount the broker has agreed with the consumer in advance will be the broker's total compensation. Under the proposal, compensation would have to be disclosed as a flat dollar amount, not as a range of fees or a percentage. The proposal will restrict only the amounts the broker retains, not amounts the broker distributes to other settlement service providers. The agreement between the broker and the consumer must also disclose that the consumer will pay the entire compensation, even if all or part is paid directly by the creditor. The broker and consumer must enter into the agreement before the consumer pays a fee to any person or submits a written application to the broker, whichever is earlier. This last requirement is intended to ensure that a consumer has not already become locked in to a relationship with the broker by paying a fee or submitting an application. The early timing requirement may also limit the risk that a broker will price discriminate on the basis of the sophistication of and market options available to the borrower.

Under the Board's proposal, the agreement between the consumer and the broker must also disclose that a creditor's payment to a broker can influence the broker to offer the consumer loan terms or products that are not in the consumer's interest or are not the most favorable the consumer could obtain. This provision may be in conflict with uncodified California law, however. Under existing California common law, a mortgage broker has a fiduciary duty to a borrower. Under that fiduciary duty, the mortgage broker is required to act in the consumer's interest. It is unclear how this discrepancy between the Board proposal and existing California law will be resolved if the Board proposal is enacted with this provision intact.

The Board's proposal would provide creditors with two alternative means with which to comply: 1) one where the creditor complies with a state law that provides consumers equivalent protection, or 2) one where a creditor can demonstrate that its payments to a mortgage broker are not determined by reference to the transaction's interest rate.

The Board is proposing the change, because it believes that "creditor payments to mortgage brokers are not transparent to consumers and are potentially unfair to them…Large numbers of consumers are simply not aware" that creditors pay brokers based on the interest rate of the loan, and the legally required disclosures currently in place seem to have limited effect in explaining to consumers how broker compensation works. "Some consumers may not even know that creditors pay brokers." Brokers commonly charge borrowers directly for a small part of their compensation, which can lead consumers to mistakenly believe that this amount is all the consumer is paying and/or all the broker is receiving. "When consumers are made aware of how much they will pay for a broker's services, they may be more likely to shop and negotiate among brokers based on broker fees, broker services, and other terms of broker contracts."

"Consumers also wrongly believe that brokers agree, or are required, to obtain the best interest rate available…Consumers who have this perception rely heavily on a broker's advice…If consumers believe that brokers protect consumers' interests by shopping for the lowest rate available, consumers will be less likely to take steps to protect their own interests when dealing with a broker."

The proposed rule would apply to third-party mortgage brokers, but not to employees of retail lenders (i.e., it would apply to DRE licensees, but not to employees of DOC-licensed finance lenders or residential mortgage lenders, nor to employees of state- or federally-chartered banks or credit unions). In clarifying this point, the Board notes that it is "aware of concerns that a rule restricting, and encouraging disclosure of lender payments to brokers but not lender payments to their employees could create an 'uneven playing field' between brokers and lenders. Creditors sometimes pay their employed loan officers on a basis similar to their payment of yield spread premiums to independent brokers. To the extent a loan originated through an employee exceeds the creditor's 'par' rate, the creditor may realize a gain from selling the loan on the secondary market and it may share some of this gain with the employee. Such payments give employees an incentive to increase the interest rate…The Board does not propose, however, to restrict creditor payments to their own employees. The Board is not aware of significant evidence that consumers perceive lenders' employees the way they often perceive independent brokers – as trusted advisors who shop for the best loan for a consumer among a wide variety of sources. Accordingly, it is not clear that a key premise of the proposal to restrict creditor payments to brokers – that consumers expect a broker has a legal or professional obligation to give disinterested advice and find the consumer the best loan available – holds true for creditor payments to their own employees."

<u>Proposal Number 2 Covering All Mortgage Loans: Prohibit creditors and mortgage brokers from coercing appraisers to misrepresent the value of a consumer's principal dwelling, and prohibit creditors from extending credit when they know or have reason to know, at or before loan consummation, that an appraiser has misstated a dwelling's value.</u>

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

According to the Board, "pressuring an appraiser to overstate or understate the value of a consumer's dwelling distorts the lending process and harms consumers." Inflated appraisals can encourage a consumer to pay more for a home than they otherwise would have and can mislead a consumer into believing he or she has more equity than they actually do. Understated appraisals, though rarer, can cause a consumer to be denied access to credit for which he or she is qualified. Inappropriate home appraisals (whether over- or understated) that are concentrated in a neighborhood can affect other appraisals and other home values, because appraisers factor the value of comparable properties into their property valuations.

California law already incorporates much of the Board's proposal, and gives our state regulators express ability to enforce it against their licensees. SB 223 (Machado), Chapter 291, Statutes of 2007, prohibited any person with an interest in a real estate transaction involving an appraisal from improperly influencing, or attempting to improperly influence, through coercion, extortion, or bribery, the development, reporting, result, or review of a real estate appraisal sought in connection with a mortgage loan. SB 223 explicitly allowed persons with an interest in a real estate transaction to ask appraiser to do any of the following: 1) consider additional, appropriate property information; 2) provide further detail, substantiation, or explanation for the appraiser's value conclusion; and/or 3) correct errors in the appraisal report.

The one element of the Board's proposal not already contained in California law is the prohibition against a creditor extending credit when they know or have reason to know that the appraisal on the property is inaccurate.

Proposal Number 3 Covering All Mortgage Loans: Prohibit mortgage loan servicers from: 1) failing to credit a consumer's periodic payment as of the date that payment is received; 2) imposing a late fee or delinquency charge on a current payment as a direct result of a consumer's failure to include in that payment a delinquency charge imposed on an earlier payment or payments (a practice known as pyramiding late fees); 3) failing to provide a current schedule of servicing fees and charges within a reasonable time of request; and/or 4) failing to provide an accurate payoff statement within a reasonable time of request.

The Board's proposal is intended to prohibit four servicing practices that the Board believes to be unfair and deceptive and that are likely to harm consumers. Requiring a servicer to credit a payment as of the date received will prevent a servicer who receives a payment on or before its due date from entering that payment on its books after the due date and triggering a late charge, interest, or other charge to the consumer. The Board's proposal would also require a servicer who specifies payment requirements in writing, but who accepts a non-conforming payment, to credit that payment within five days of its receipt.

The Board's proposal against the pyramiding of late fees is intended to give state attorneys general the ability to enforce this rule uniformly. The Board notes that servicers are already subject to this rule under a variety of different laws and regulations (different laws apply to different types of financial institutions). Including the prohibition against pyramiding within TILA will allow states to enforce it more uniformly and give states an additional means of enforcement.

Promptly providing consumers with schedules of all specific fees and charges that may be imposed in connection with the servicing of the consumer's account, including a dollar amount, an explanation of each charge, and the circumstances under which the charge may be imposed, will make it more difficult for unscrupulous servicers to camouflage or inflate fees. The dollar amount of each charge may be expressed as a flat fee or, if a flat fee is not feasible, an hourly rate or percentage. Servicers may comply with this requirement by either mailing the schedule to a consumer or directing the consumer to a specific website where the schedule is posted.

Prompt provision of a loan payoff statement to the consumer or the person acting on behalf of the consumer is intended to prevent unscrupulous servicers from delaying or preventing consumers from refinancing existing loans or otherwise clearing title to their properties. Such delays increase transaction costs and may discourage consumers pursuing a refinance opportunity. The Board believes that under normal market conditions, three business days would be considered a reasonable period of time in which to provide the payoff statement, but this time period might be extended when servicers are experiencing an unusually high volume of refinancing requests.

Proposals Governing Advertising Rules

The Board's advertising proposals are segregated into two separate categories – those applying to open-end HELOCs, and those applying to closed-end credit transactions.

Advertising Proposals Governing HELOCs

According to the Board, the two most significant changes to its advertising rules governing HELOCs relate to the "clear and conspicuous" standard and the advertisement of introductory terms in home equity plans.

Under existing law, if an open-end credit advertisement sets forth, either affirmatively or negatively, any of the specific terms of the plan, including any required periodic payment amount, the advertisement must also clearly and conspicuously state: 1) any loan fee and an estimate of the aggregate amount of other fees for opening the account, 2) in any case in which periodic rates may be used to compute the finance charge, the periodic rates expressed as an APR, 3) the highest APR that may be imposed under the plan, and 4) any other information the Board requires through regulation. Specific terms of an open-end plan that trigger additional disclosures (so-called "triggering terms") include the payment terms of the plan and its finance charges.

The Board's proposal would elaborate on the requirement that certain disclosures about introductory rates or payments in advertisements for home equity plans be prominent and in close proximity to the triggering terms. Disclosures would be acceptable under the proposal if they appear immediately next to or directly above or below the trigger terms, without any intervening text or graphical displays. Terms required to be disclosed with equal prominence to the introductory rate or payment would be deemed to meet this requirement if they appear in the same type size as the introductory rate or payment amounts.

The equal prominence and close proximity requirements would apply to all visual text advertisements. Rules are also provided for electronic advertisements, to ensure that each triggering term is accompanied by a link that takes the consumer directly to the additional information. Oral advertisements must provide disclosures at a speed and volume sufficient for a consumer to hear and comprehend them. The proposal clarifies that in this context, the word "comprehend" means they must be intelligible, not that advertisers must ensure that consumers understand their meaning. The Board is also proposing to allow the use of a toll-free telephone number as an alternative to certain oral disclosures in television and radio advertisements.

With respect to the advertisement of introductory rates and payments, the proposal provides that if an advertisement for a HELOC states an introductory rate or payment, the advertisement must use the term "introductory" or "intro" in immediate proximity to each mention of the introductory rate or payment. The proposed rule also provides that advertisements must disclose the following information in a clear and conspicuous manner with each listing of the introductory rate or payment: 1) the period of time during which the introductory rate or payment will apply, 2) any APR that will apply under the plan, 3) the amounts and time periods of payments that will apply under the plan. In variable-rate transactions, payments that will be determined based on the application of an index and a margin to an assumed balance must be disclosed based on a reasonably current index and margin. The Board's proposal includes safe-harbor definitions for the phrase "reasonably current index and margin."

Advertising Proposals Governing Closed-end Credit

According to the Board, the three most significant changes to rules governing advertisements for closed-end, home-secured loans relate to strengthening the clear and conspicuous standard for advertising disclosures, regulating the disclosure of rates and payments in advertisements to ensure that low introductory or teaser rates or payments are not given undue emphasis, and prohibiting seven specific acts or practices in connection with advertisements that the Board finds to be unfair, deceptive, associated with abusive lending practices, or otherwise not in the interest of the borrower.

The proposed rules governing the clear and conspicuous standard and the provision of information about rates and payments are sufficiently similar to the changes proposed for open-end loans described immediately above that the discussion above will not be reproduced here. Among the impacts of these proposed changes on advertisements for closed-end credit transactions: advertisements for home-secured loans will no longer be allowed to state any rate other than an APR or a simple annual rate that is applied to an unpaid balance. A rate lower than the rate at which interest is accruing (such as an effective rate, payment rate, or qualifying rate), can no longer be included in advertisements for home-secured loans. Similarly, an advertisement for a discounted variable-rate transaction must show, with equal prominence, and in close proximity to its reduced or discounted simple annual rate, the limited term to which the simple annual rate applies and the APR that will apply after the term of the initial rate expires.

Advertising relating to the terms of repayment must reflect the repayment obligations over the full term of the loan, including any balloon repayment, not just the repayment terms that will apply for a limited period of time. Furthermore, in advertisements for home-secured loans with one series of low monthly payments followed by another series of higher monthly payments, the advertisement must state the amounts of both sets of payments. The amount of the higher payments would have to be based on the assumption that the consumer makes the lower series of payments for the maximum allowable period of time. Without these disclosures, the Board is concerned that consumers may not fully understand the cost of the loan or the payment terms that may result once the higher payments take effect.

The Board is also proposing to prohibit seven acts and practices in mortgage advertisements, as follows: 1) using the term “fixed” in connection with ARMs or in connection with fixed-rate mortgages that include low initial payments that will increase, unless several conditions intended to clarify the actual nature of the mortgage are satisfied; 2) making comparisons between an actual or hypothetical consumer’s current payments or rates and the payments or simple annual rate that will be available under the advertised product for less than the terms of the loan, unless conditions intended to clarify the actual payments and rate of the advertised loan are satisfied; 3) misrepresenting the availability of a government endorsement on loans that are not government-supported or endorsed; 4) misleadingly using a consumer’s current mortgage lender’s name in an advertisement, without clear disclosure of the name of the business sending the advertisement, together with a clear and conspicuous statement that the person making the advertisement is not associated with or acting on behalf of the consumer’s current lender; 5) misleadingly asserting that a loan will eliminate, cancel, wipe out, waive, or forgive debt; 6) misleadingly suggesting a fiduciary or other relationship that does not exist; and 7) mixing English and a foreign language in foreign-language advertisements (the Board is proposing to ban advertisements that specify certain terms and disclosures in a foreign language and other terms and disclosures in English; its proposal does not extend to advertisements entirely in English or entirely in a foreign language).

Both DOC and DRE already apply stringent advertising requirements to their licensees that go beyond the requirements in federal law. Although both departments have long prohibited false and misleading advertising, both recently updated and strengthened their advertising requirements, in response to enactment of SB 385 (Machado), Chapter 301, Statutes of 2007. Both departments will be available to discuss the extent to which their advertising regulations already incorporate many of the changes proposed to Regulation Z by the Board.

Proposal Governing Consumer Disclosures

Under TILA, a mortgage loan disclosure form must be delivered to a borrower before credit is extended. A separate rule applies to purchase-money, residential mortgage transactions covered by the Real Estate Settlement Procedures Act, and requires that good faith estimates of the costs associated with a mortgage loan be provided to the borrower before the credit is extended, or delivered or placed in the mail not later than three business days after the creditor receives the consumer's written application, whichever is earlier.

The Board proposes to amend Regulation Z to extend both requirements above to refinancings, home equity loans, and reverse mortgages, to the extent they involve transactions secured by a consumer's principal dwelling. The Board also proposes to require that the early mortgage loan disclosure be delivered to the consumer before he or she pays a fee to any person in relation to the mortgage loan transaction. The only exception to the fee provision would involve fees paid to allow a creditor to obtain information on the consumer's credit history. The Board felt it was unfair to require creditors to bear the cost of reviewing credit history, with little assurance that the customer would apply for a loan.

As rationale for this proposed change, the Board notes that "under the current rule, creditors need not deliver mortgage loan disclosures on non-purchase money mortgage transactions until consummation. By that time, consumers may not be in a position to make meaningful use of the disclosure. Once consumers have reached the settlement table, it is likely too late for them to use the disclosure to shop among mortgages or to inform themselves adequately of the terms of the loan. Consumers are presented at settlement with a large, often overwhelming, number of documents, and they may not reasonably be able to focus adequate attention on the mortgage loan disclosure. Moreover, by the time of loan consummation, consumers may feel committed to the loan because they are accessing their equity for an urgent need, or they have already paid substantial application fees.

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

In its proposal, the Board also expressed its intention to update the disclosure forms it requires be used in residential real estate transactions. In early 2008, the Board will begin consumer-testing current TILA mortgage disclosures and potential revisions to these disclosures. The Board expects that this testing will identify potential improvements, which the Board will propose in a separate rulemaking.

EFFECTIVE DATE OF PROPOSED REGULATORY CHANGES

Under TILA, new regulations become effective on the October 1st which follows the date of regulatory promulgation by at least six months. The Board may, however, shorten or lengthen this period upon making specified findings.