

Proposed Amendments to Regulation Z Relating To Closed-End Mortgages and Home-Equity Lines of Credit

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In this article, the authors summarize the Federal Reserve Board's recent proposal to amend Regulation Z in regard to closed-end mortgages and home equity loans.

On July 23, 2009, the Federal Reserve Board ("Board") released a proposal to amend Regulation Z, which implements the Truth in Lending Act ("TILA"). The proposal would set new disclosure rules governing closed-end mortgages (including closed-end home equity loans). It would impose restrictions on how mortgage brokers and loan officers may be compensated for their services in connection with closed-end mortgages. The proposal also would set new disclosure rules governing home-equity lines of credit ("HELOCs") and provide guidance on the termination, suspension, credit limit reduction, and reinstatement of a HELOC plan. Public comments on the proposal are due by December 24, 2009. A summary of the proposal follows.

Disclosure Requirements for Closed-End Mortgages

The proposal would amend Regulation Z to impose new disclosure requirements and to amend the existing disclosure requirements for closed-end mortgages. Model forms have been proposed for the required disclosures. As a result of the proposal,

disclosures would be required at four different times during the mortgage process:

- (1) At application;
- (2) Within three days after application;
- (3) Three days before the loan closing; and
- (4) After the loan closing.

Following, each proposed requirement is outlined.

- *Disclosures at Application:* First, creditors would be required to make certain disclosures before the consumer applies for a loan or pays a nonrefundable fee, whichever is earlier.
 - The creditor would be required to provide two one-page Board publications, regardless of the type of loan the consumer inquires about. The Board has created these publications in connection with the proposal. The first one is entitled "Key Questions to Ask about Your

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Mortgage” and it is designed to inform consumers that a mortgage loan can have risky features such as interest rate increases, monthly payment increases, negative amortization, prepayment penalties, and balloon payments. The other publication is entitled “Fixed vs. Adjustable Rate Mortgages” and explains the basic differences between fixed-rate and adjustable-rate mortgages.

- For a consumer who expresses an interest in an adjustable-rate mortgage, the creditor would be required to provide additional disclosures. But the disclosures would be simpler than the adjustable-rate mortgage disclosures currently required under Regulation Z, and they would focus on interest rate and payment information, as well as potentially risky features of the particular loan program. The disclosures would be provided in a tabular question and answer format.
- *Disclosures within Three Days after Application:* Second, the proposal would modify the content and format of disclosures that must be provided to the consumer within three days after application (early disclosure statement).
 - The proposal would define what is included in the “finance charge” more broadly, and thus exclusions from the finance charge would be more limited. Fees or charges paid in comparable cash transactions, such as transfer taxes, would continue to be excluded from the finance charge, but other exclusions

generally would be limited to late fees and similar default or delinquency charges, seller’s points, and premiums for property and liability insurance. For example, under the proposal, title examination and document preparations fees, which are currently excluded, would be included in the finance charge. As a result of this more inclusive approach, a higher finance charge and, correspondingly, a higher annual percentage rate (“APR”) would need to be disclosed for the same loan costs.

- Under the proposal, creditors would disclose the finance charge as “interest and settlement charges” but would not need to make the term more conspicuous than the other required disclosures.
- The proposal would require creditors to disclose the APR in 16-point type together with a statement that the APR represents the overall cost of the loan, including interest and settlement charges. With certain exceptions, the proposal also would require creditors to show the APR plotted on a graph, relative to (1) the average prime offer rate (“APOR”), which is an average of rates offered to borrowers with excellent credit for a comparable loan type, as published by the Board, and (2) the higher-priced loan threshold, which is 1.5 percentage points higher than the APOR for a first lien mortgage or 3.5 percentage points higher than the APOR for a second lien mortgage (rates above the high-priced

loan threshold are generally offered to borrowers considered bad credit risks or with high loan-to-value ratios).

- The proposal would require creditors to disclose in a table the contract interest rate together with the corresponding monthly payment, including escrows for taxes and insurance. For adjustable-rate or step-rate loans, the creditor must show the interest rate and payment at consummation, the maximum interest rate and payment at first adjustment, and the highest possible maximum interest rate and payment. For loans with negatively-amortizing payment options, introductory interest rates, interest-only payments, or balloon payments, the creditor would be required to provide special disclosures.
- The proposal would require creditors to provide, in a table, information about the loan amount, the loan term, the loan type (such as fixed-rate or adjustable-rate), the total settlement charges, and the maximum amount of any prepayment penalty. Creditors would also be required to set out the following information in a table under the heading "Key Questions about Risk": interest rate increases, payment increases, and prepayment penalties, and if applicable, interest-only payments, negative amortization, balloon payments, demand features, no-documentation or low-documentation loans, or shared-equity or shared-appreciation features.
- The proposal states that the Board recognizes that the Regulation Z disclosures on settlement charges, as proposed, would overlap with the good faith estimate and HUD-1 settlement state-

ment required by the Real Estate Settlement Procedures Act ("RESPA"), which is administered by the U.S. Department of Housing and Urban Development ("HUD"). It raises the possibility of the Board's working with HUD to develop a single form that would meet the disclosure requirements administered by both agencies.

- *Disclosures Three Days before Consummation:* Third, the proposal would require the creditor to provide a final disclosure statement at least three business days before consummation (final disclosure statement), even if the early disclosure statement, provided within three days after application, remains accurate. The proposal offers for comment two alternative approaches to situations where the settlement costs or loan terms change during the three-business-day waiting period before the closing. Under the first approach, the creditor would automatically be required to provide another final disclosure statement, followed by another three-business-day waiting period. Under the second approach, the obligation to provide another final disclosure statement, followed by another three-business-day waiting period, would be triggered only if the APR increase exceeds a certain tolerance or the creditor adds an adjustable-rate feature.
- *Disclosures after Consummation:* Finally, the proposal would impose new disclosure requirements after consummation.
 - For an adjustable-rate mortgage, the proposal would require the creditor to provide an interest rate adjustment notice at least 60 days before payment at a new level is

due. The notice would contain a table with a comparison of current and new interest rate and payment information, along with the due date for the new payment.

- For a negatively-amortizing loan, the proposal would require the creditor to provide a periodic statement that would contain a table comparing the amount of a fully-amortizing payment, an interest-only payment, and a minimum negatively-amortizing payment, as well as how each type of payment would affect the loan balance and equity in the property differently. The periodic statement would be provided at least 15 days before a periodic payment is due.
- The proposal would require the creditor to provide notice of the cost and coverage of creditor-placed property insurance at least 45 days before imposing a charge for such insurance, and to provide evidence of such insurance within 15 days of imposing the charge. This would add to the current notice requirements relating to mortgage loans, such as the new creditor notice requirement under the TILA and the transfer of servicing rights notice requirement under the RESPA.

Prohibitions on Payments to Loan Originators and Steering

In addition to the disclosure rules, the proposal would prohibit loan originators (including mortgage brokers and loan officers) from receiving compensation based on the terms or conditions of a credit transaction, unless

the payments are made by a consumer directly to the loan originator. This would prohibit compensation such as yield spread premiums. Also, if a consumer directly pays a loan originator, the loan originator would be prohibited from receiving compensation for the same credit transaction from any other party. The proposal would also prohibit a loan originator from steering a consumer to a loan that is not in the consumer's best interest for the purpose of increasing the loan originator's compensation. These prohibitions would not apply to HELOCs.

Disclosure Requirements for Home Equity Lines of Credit

The proposal would also amend Regulation Z to impose new disclosure requirements and to amend the existing disclosure requirements for HELOCs. Model forms have also been proposed for the required disclosures. As a result of the proposal, the following five main types of disclosures would be required for HELOCs:

- (1) Disclosures at application;
- (2) Disclosures within three days after application;
- (3) Disclosures at account opening;
- (4) Periodic statements; and
- (5) Change-in-terms notices.

Each proposed requirement is outlined below.

- *Disclosures at Application:* First, the proposal would require the creditor to provide a one-page Board publication entitled "Key Questions to Ask about Home Equity Lines of Credit" at the time of application. The Board has created

the publication in connection with the proposal. This publication would inform consumers about important HELOC terms and risks, including adjustable rates and balloon payments.

- *Disclosures within Three Days after Application:* Second, the proposal would require that the creditor provide disclosures specific to the actual credit terms for which the consumer qualifies within three business days after application and no later than account opening (early HELOC disclosures). Such disclosures would need to be provided in a table with the required headings, content, and format. The disclosures would include: (1) the APRs and credit limit being offered; (2) a statement that the creditor will acquire a security interest in the consumer's dwelling and that the consumer may lose the dwelling in the event of default; (3) a statement that, under certain conditions, the consumer may be responsible for a balloon payment; and (4) payment examples for the current APR and the maximum APR for each payment plan disclosed (the proposal would allow the creditor to disclose a maximum of two payment plans in the table), on the assumption that the consumer would borrow the full credit line at the beginning of the draw period and then draw no additional advances. Additionally, the early HELOC disclosures would need to state that the consumer has no obligation to accept the terms disclosed in the early HELOC disclosures. If the creditor requests the consumer's signature on the early HELOC disclosure statement, it must state that such a signature only confirms receipt of the disclosure statement.
- *Disclosures at Account Opening:* Third,

the proposal would require that the creditor provide account opening disclosures in a table that summarizes specific costs and terms. The account opening table would be similar to the table in the early HELOC disclosures, but it would show only the payment plan chosen by the consumer (whereas the early HELOC disclosures could disclose two payment plans), and would contain transaction fees and penalty fees not required to be disclosed in the early HELOC disclosures.

- *Periodic Statements:* Fourth, the proposal would eliminate the current requirement to disclose the effective APR. It would require creditors to describe all charges either as "interest" or as a "fee," without characterizing particular charges as "finance charges." The proposal would also require creditors to disclose separately the total fees and the total interest imposed for each billing cycle, and also separately the total fees and total interest for the year to date.
- *Change-in-Terms Notices:* Fifth, the proposal would require advance notice of any rate increase, even if the event triggering the increase, such as loss of an employee preferred rate, is specified in the agreement. Similar to the Credit Card Accountability Responsibility and Disclosure Act of 2009 ("CARD Act"), which requires 45 days' written notice to a cardholder of any significant changes in the terms of a credit card account, the proposal would require that any change-in-terms notice be sent 45 days in advance. Moreover, the proposal would impose certain format requirements. For example, if a changed

term is one that must be provided in the account opening summary table, the creditor would be required to provide that change in a summary table.

Additional Guidance for Home-Equity Lines of Credit

Furthermore, the proposal provides additional guidance regarding account terminations, suspensions and credit limit reductions, and account reinstatements for HELOC plans.

- *Account Terminations:* under the proposal, a creditor would not be permitted to terminate a HELOC plan for late payment unless the consumer has failed to make a required minimum periodic payment for more than 30 days after the due date for that payment. No comparable restriction on account termination currently exists under the CARD Act or Regulation Z with respect to non-HELOC open-end line of credit products.
- *Suspensions and Credit Limit Reductions Based on a Significant Decline in Property Value:* A creditor may temporarily suspend advances or reduce the credit limit on a HELOC plan when there is a significant decline in the value of the property securing the plan. The proposal would provide two safe harbors for determining whether a decline in property value is significant. First, for plans with a combined loan to value ("CLTV") at origination of 90 percent or higher, a five percent reduction in property value is significant. Second, for plans with a CLTV at origination of under 90 percent, a decline in property value that causes the creditor's equity cushion to be reduced by 50 percent or more is significant.

- *Suspensions and Credit Limit Reductions Based on a Material Change in the Consumer's Financial Circumstances:* A creditor may suspend advances or reduce the credit limit on a HELOC when the creditor reasonably believes that the consumer will be unable to meet payment obligations because of a material change in the consumer's financial circumstances. The proposal would clarify that evidence of a material change in financial circumstances may include credit report information showing late payments or failures to make payments, or public records relating to the consumer's failure to pay other obligations. The proposal would also clarify that any payment failures on which the creditor relies to show a material change in the consumer's financial circumstances would need to have occurred within a reasonable time from the date of the creditor's review of the consumer's credit performance. A six-month safe harbor has been proposed for purposes of determining a reasonable time.
- *Account Reinstatements:* The proposal would require additional disclosures in notices of suspension or credit limit reduction about the consumer's ongoing right to request reinstatement and the creditor's obligation to investigate such requests. It would require the creditor to complete investigating such a request within 30 days of receiving the request and to provide notice of the results to the consumer if the consumer's credit privileges would not be reinstated. It would also require the creditor to cover the costs associated with investigating the first reinstatement request made by

the consumer after the line is suspended or reduced.

Conclusion

The Board's proposed amendments to Regulation Z are significant and would create heightened disclosure requirements for creditors offering closed-end mortgages as well as HELOCs. These amendments are consistent with recent legislation such as the CARD Act, which indicates a growing sentiment of the Congress in favor of stricter disclosure

requirements in the consumer lending context. They bring into focus the Board's efforts to curb some of the lending practices that have been perceived as contributing to the current financial crisis. These proposed amendments may also be an effort by the Board's staff to show Congress and others that the Board is the appropriate regulator to enforce the consumer finance laws, rather than the Consumer Financial Protection Agency proposed by the Obama Administration and being considered by the Congress.