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RETHINKING DISCLOSURE IN A WORLD OF RISK-BASED PRICING

PATRICIA A. MCCOY*

In response to subprime loan abuses, it is common for policymakers to exhort consumers to comparison-shop for residential mortgages. This policy prescription ignores the fact that price revelation works differently in the prime and subprime markets, impeding search in subprime. In the prime market, lenders reveal firm prices for free, without requiring consumers to first submit loan applications. This dynamic, combined with Truth-in-Lending Act (TILA) disclosures that standardize prices, make it easy to comparison-shop for prime mortgages. In contrast, in the subprime market featuring risk-based pricing, consumers must reveal their creditworthiness before lenders can determine loan prices, which allows lenders to delay price revelation until after taking loan applications.

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In numerous cases, subprime borrowers do not learn firm prices until closing, due to a lack of lock-in commitments and behind-the-scenes negotiations over broker compensation. As a result, the subprime market is a pay-to-play market where customers must often pay several hundred dollars in application and appraisal fees (and wait until closing) to discover actual prices. This process makes meaningful comparison-shopping prohibitively expensive and promotes oligopolistic pricing in the subprime market.

The same price revelation dynamics cause Truth-in-Lending Act disclosures to break down for subprime loans. TILA allows subprime lenders to advertise their best rates alone, misleading customers with weaker credit. In addition, TILA does not require lenders to reveal binding prices until closing (except for high-cost refinance home mortgages). Finally, TILA disclosures for traditional adjustable-rate mortgages, interest-only mortgages, and option ARMs are hopelessly complex. The article concludes by proposing reforms to federal disclosure laws to permit meaningful comparison-shopping and promote price competition in the subprime mortgage market.

In recent years, the mortgage debt of ordinary homeowners has mounted, garnering widespread attention and concern. Policymakers exhort consumers to minimize their cost of credit by comparison-shopping for home mortgages. But calls for comparison-shopping ignore the fact that certain consumers--specifically, individuals with poor

credit--face informational barriers that make meaningful comparison-shopping for mortgages nearly impossible. In view of these barriers, it is not at all surprising, as a leading scholar noted fifteen years ago, that shopping for credit "remains extremely limited--limited to the same upscale consumers who would manage perfectly well without benefit of legislation."[1]

The system of mandatory mortgage disclosures in the United States was designed for the old world of prime loans. The Truth in Lending Act and the Real Estate Settlement Procedures Act were both enacted to remove informational barriers to consumer search for residential mortgages.[2] These statutes were written when the sole conventional mortgage market was the prime market and access to home mortgages was limited to customers with strong credit.

Since then, the U.S. residential mortgage market

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[1] Edward L. Rubin, Legislative Methodology: Some Lessons from the Truth-in-Lending Act, 80 GEO. L.J. 233, 236 (1991).

[2] See Truth in Lending Act, Pub. L. No. 90-321, tit. I, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601 - 1693 (2000)); Real Estate Settlement Procedures Act, Pub. L. No. 93-533, 88 Stat. 1724 (1974) (codified as amended at 12 U.S.C. §§ 2601 - 2617 (2000)); *see also* Rubin, *supra* note 1, at 233.

has undergone rapid change. The market has evolved from strictly a prime market based on average-cost pricing (in which comparable mortgages have roughly one price) to a dual market offering both prime loans and subprime loans featuring risk-based pricing (in which the price for a given mortgage varies according to the borrower's risk).[3]

However well traditional mortgage disclosure rules work in prime market conditions, these rules break down in the subprime world of risk-based pricing. Numerous subprime advertisements are tantamount to affirmative misrepresentations for most customers with blemished credit because lenders generally tout only their best rates. Subprime lenders do not provide firm price quotes to customers before application and often not until closing, when it is too late to shop. Similarly, lock-in commitments,[4] which are customary in the prime market,

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[3] Subprime loans are designed for borrowers with weaker credit and for borrowers who want low-documentation or no-documentation loans. *See* Elizabeth Renuart, *An Overview of the Predatory Mortgage Lending Process*, 15 HOUSING POL'Y DEBATE 467, 474 (2004), *available at* http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1503_Renuart.pdf.

[4] A lock-in commitment is "a lender's promise to hold a certain interest rate and a certain number of

are rarely ever seen in the subprime world.

If comparison-shopping means anything, it means the ability to obtain firm apples-to-apples price quotes from multiple lenders without having to pay large, nonrefundable fees. Unfortunately, most subprime customers lack that ability. Instead, under current federal disclosure laws, subprime lenders can entice customers with rosy prices that are not available to weaker borrowers, hike the price after customers pay a hefty application fee, then raise the price again at closing, often with no advance notice. Under these circumstances, our broken system of federal mortgage disclosures impedes meaningful comparison-shopping and efficient subprime prices.

This state of affairs is not inevitable. Subprime lenders and mortgage brokers have the technology and information they need right now to provide firm price quotes to consumers at minimal cost without extracting large application fees. Requiring lenders and brokers to use this technology

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points for [a loan applicant], usually for a specified period of time, while [the applicant's] loan application is processed." BD. OF GOVERNORS OF THE FED. RESERVE SYS., A CONSUMER'S GUIDE TO MORTGAGE LOCK-INS 2, *available at* http://www.federalreserve.gov/pubs/lockins/default.htm.

to provide firm quotes would revolutionize consumer search in the subprime world. Similarly, minor changes to federal regulations governing subprime mortgage advertising could help alleviate the current state of rampant misrepresentations and misleading omissions in the subprime market. Advance disclosure of legitimate changes in loan terms at least a week before closing would further constrain bait-and-switch tactics. Finally, revamped disclosure rules for variable-rate[5] loans would help consumers understand their worst case payment scenario, which is the biggest risk presented by these loans.

This Article proceeds as follows: Part I describes how the residential mortgage market has evolved from a prime market based on average-cost pricing to a dual market that also uses risk-based pricing. Part II provides a thumbnail description of the relevant provisions of federal mortgage disclosure law. Part III explains why the market

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[5] In a variable-rate loan "[t]he interest rate fluctuates over the life of the loan based on market conditions, but the loan agreement generally sets maximum and minimum rates." BD. OF GOVERNORS OF THE FED. RESERVE SYS., LOOKING FOR THE BEST MORTGAGE: SHOP, COMPARE, NEGOTIATE, *available at* www.federalreserve.gov/pubs/mortgage/mortb_1.htm.

dynamics of the subprime market cause the traditional disclosure rules to break down. Part IV sets forth this Article's proposals for reforming the disclosure rules to permit meaningful comparison-shopping in the subprime market.

I. The Old World and the New

In the 1960s and 1970s, when current federal mortgage disclosure laws were enacted, the mortgage world was a different place. Individuals with poor credit were systematically excluded from conventional credit, lenders gave free price quotes, lock-in commitments were common, and mortgages with comparable features went for approximately the same price. Congress designed federal disclosure laws with these market conditions in mind. In subsequent decades, when market conditions evolved and credit became available to weaker borrowers at higher, risk-adjusted prices, the disclosure laws began to show their age.

A. *The Old World Of Average-Cost Pricing*

Before 1990, mortgage lenders generally restricted home loans to prime borrowers, who are individuals with strong credit. Lenders rationed credit because demand exceeded supply.[6] People who banks categorized as risky could not get conventional home mortgages.[7] Furthermore, many lenders stereotyped blacks, Hispanics, and members of other minority groups as inherently risky and categorically denied them loans.[8]

In this market, known as the "prime market," lenders price mortgages based on average cost. Prime borrowers have narrow differences in credit risk. Lenders do not adjust the price for prime mortgages, however, based on these differences in risk. Instead, under average-cost pricing, a lender aggregates individual credit risks and computes one price for all of its prime borrowers based on the average. As a result, for any given loan product,

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[6] *See* Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 393 - 95 (1981) (providing a theoretical justification for credit rationing at market equilibrium).

[7] *See id.*

[8] *See, e.g.*, PATRICIA A. MCCOY, BANKING LAW MANUAL: FEDERAL REGULATION OF FINANCIAL HOLDING COMPANIES, BANKS AND THRIFTS § 8.04[1], nn. 1 - 8 (2d ed. 2000 & Supps.).

such as a thirty-year fixed-rate mortgage with no points, a lender will charge all of its prime borrowers an identical price.[9]

Under average-cost pricing, not every loan applicant will qualify for and receive a loan. Instead, average-cost pricing amounts to a pass-fail system. If the applicant qualifies, she receives the standard price. If she does not, the lender denies the loan outright.[10]

Average-cost pricing has two important implications for efficient pricing. First, prices for prime mortgages with comparable features are highly competitive and trade within a relatively narrow band.[11] Similar mortgages have roughly homogeneous prices. Second, this price competition gives prime borrowers leverage to demand concessions from lenders in the form of lock-in commitments, interest rate reductions in exchange for points, and the general absence of prepayment penalties.[12]

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[9] *See* Arnold S. Kling, *Get Set for Loan-Level Pricing*, SMM MAG. (ANNUAL MORTGAGE MARKET TRENDS ISSUE), July 1997, at 17, *available at* http://www.freddiemac.com/finance/smm/july97/pdfs/kling.pdf.
[10] *See id.* at 17 - 18, 20.
[11] *See id.*
[12] *See, e.g.*, CTR. FOR RESPONSIBLE LENDING, BORROWERS GAIN NO INTEREST RATE BENEFITS FROM PREPAYMENT PENALTIES ON SUBPRIME

B. *The New World of "Risk-Based" Pricing*

Starting in the late 1970s and continuing through the early 1990s, a confluence of legal, technological, and market forces caused the residential mortgage market in the United States to undergo wholesale transformation.[13] These changes resulted in the emergence of the subprime mortgage market, which is designed for borrowers with poor credit and charges higher interest rates and fees than the prime market. The subprime market charges different borrowers different prices for the same product, ostensibly based on their individual risk.

In theory, such "risk-based pricing" pigeonholes borrowers according to risk and calibrates prices accordingly. This leads to multiple prices for the same loan. The price of the loan goes up as the

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MORTGAGES 2 - 3 (2005), *available at* http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf; CONG. BUDGET OFFICE, EFFECTS OF REPEALING FANNIE MAE'S AND FREDDIE MAC'S SEC EXEMPTIONS 24 & nn. 48 - 49 (2003), *available at* http://www.cbo.gov/ftpdocs/41xx/doc4199/05-06-03-GSEs.pdf; David Reed, *Understanding Mortgage Rates, Points, and Fees*, REALTY TIMES, Mar. 31, 2006, http://www.realtytimes.com/rtcpages/20060331_understanding.htm.

[13] *See* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1273 - 80 (2002).

borrower's creditworthiness goes down.[14] A subprime lender, for example, may differentiate prices according to a complex matrix of factors, including credit scores, loan-to-value ratios, debt ratios, and prepayment risk.[15]

At this point, it is important to add a caveat: in reality, "risk-based pricing" is a misnomer. "Risk-based pricing" implies that pricing is accurately calibrated to credit risk. In reality, prices in the subprime market are only partly based on differences in borrowers' risk. Other factors, including mortgage broker compensation, discrimination, and rent-seeking can and do push up subprime prices.[16] This phenomenon has resulted in well-publicized abuses in the subprime market.[17]

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[14] *See* Kling, *supra* note 9, at 17 - 18; Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUSING POL'Y DEBATE 533, 556 - 63 (2004), *available at* http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1503_Lax.pdf.

[15] *See* Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, 15 HOUSING POL'Y DEBATE 503, 509 - 12 (2004).

[16] *See, e.g.*, Lax et al., *supra* note 14, at 565 (finding that "some borrowers end up with subprime loans for reasons other than risk" and calling that finding "disturbing").

[17] *See, e.g.*, Engel & McCoy, *supra* note 13, at 1259 - 70, 1280 - 98.

Accordingly, this Article uses the term "risk-based pricing" in its weak sense to refer to individualized pricing that may or may not be accurately tailored to a borrower's risk.

II. Federal Law Governing Price Revelation in the Home Mortgage Markets

In thinking about whether comparison-shopping is feasible in the subprime market, it is necessary to analyze how prices are revealed to consumers. In both the prime and subprime markets, price revelation is the result of interaction between market forces and federal (as well as state) disclosure laws. Such interaction varies, often dramatically, depending on whether a consumer is shopping in the world of average-cost or risk-based pricing.

This Article focuses on federal disclosure laws governing closed-end residential mortgages (other than reverse mortgages),[18] which are often associated

[18] Closed-end mortgages are loans that finance fixed amounts of principal. Open-end mortgages, in contrast, are lines of credit in which the amount financed varies between zero and a dollar limit stated in the loan contract, at the borrower's option. *See generally* Elizabeth Renuart & Kathleen Keest,

with subprime lending abuses. Two major federal disclosure laws--the Truth in Lending Act ("TILA")[19] and the Real Estate Settlement Procedures Act ("RESPA")[20]--mandate disclosures about the costs associated with most residential mortgages. RESPA requires standardized disclosures about the settlement costs of residential mortgages.[21] TILA requires lenders to disclose the cost of credit in two standardized formats: the finance charge and the annual percentage rate ("APR").[22] The finance charge seeks to capture the total dollar cost that a borrower will pay for credit, including interest

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NAT'L CONSUMER LAW CTR., TRUTH IN LENDING § 4.1.2 (5th ed. 2003 & Supps.) (discussing open-end and closed-end credit); BD. OF GOVERNORS OF THE FED. RESERVE SYS., WHAT YOU SHOULD KNOW ABOUT HOME EQUITY LINES OF CREDIT, *available at* www.federalreserve.gov/pubs/equity/equity-englig h.htm (comparing traditional mortgages with home equity lines of credit). Reverse mortgages are "transactions in which payments are due only upon transfer of the dwelling in which the security interest is taken or when the consumer dies or moves." RENUART & KEEST, *supra*, § 4.1.2.

[19] 15 U.S.C. §§ 1601 - 1693 (2000). One section of TILA, the Home Ownership and Equity Protection Act ("HOEPA"), mandates stricter disclosures for the most expensive subprime loans. For a description of HOEPA's disclosure rules, see *infra* notes 66 - 72 and accompanying text.

[20] 12 U.S.C. §§ 2601 - 2617 (2000).

[21] *See infra* Part II.B.2.

[22] *See infra* Part II.B.1.

payments, points, origination fees, and private mortgage insurance. The APR provides a different metric of the total cost of credit by converting the finance charge into an effective interest rate per year.[23] The Federal Reserve Board promulgates regulations implementing TILA, while the Department of Housing and Urban Development ("HUD") implements RESPA.[24]

A. *Regulation of Price Revelation in General Advertising*

Often, consumers shop for products by comparing prices in general advertisements. Neither TILA nor RESPA requires lenders to advertise prices. Consequently, when lenders advertise the cost of credit, they do so voluntarily.

TILA lightly regulates the content of loan

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[23] *See generally* BD. OF GOVERNORS OF THE FED. RESERVE SYS. & DEP'T OF HOUS. & URBAN DEV., JOINT REPORT TO THE CONGRESS, CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT, at I - II (1998) [hereinafter HUD-FED JOINT REPORT], *available at* http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

[24] *See* 15 U.S.C. § 1604(a); 12 U.S.C. §§ 2602(6), 2617(a).

advertisements, while RESPA does not regulate advertisements at all. TILA's provisions require lenders to make standardized disclosures whenever other price terms are advertised. Specifically, any advertisement that states an interest rate must state the annual percentage rate.[25] Written advertisements may also state a simple, periodic nominal interest rate to be applied to an unpaid balance so long as that rate is no more conspicuous than the APR.[26] Oral responses to consumer inquiries about rates for closed-end loans, in contrast, may only state the APR.[27] Finally, any advertisement that quotes any of four types of loan terms--a down payment by percentage or amount, the amount of any monthly loan payment or finance charge, the number of payments, or the period of repayment--must also state the APR, the terms of repayment, and the amount or percentage of any down payment.[28]

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[25] 15 U.S.C. § 1664(c); 12 C.F.R. § 226.24(b) (2005).
[26] 15 U.S.C. § 1664(c); 12 C.F.R. § 226.24(b).
[27] 15 U.S.C. § 1665(a); *see also* 12 C.F.R. § 226.26(b) (creating an exception providing "that a simple annual rate or periodic rate also may be stated if it is applied to an unpaid balance"); *cf. id.* § 226.26(a) (governing open-end credit).
[28] 15 U.S.C. § 1664(d); 12 C.F.R. § 226.24(c); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.24(c); *cf.* 12 C.F.R. § 226.16(d)

Other provisions of TILA prohibit specific types of misrepresentations or misleading omissions in advertising. Thus, lenders may not advertise specific credit terms, such as APRs or minimum down payments (such as "zero down payment" or "only 5% down") unless they actually offer those terms.[29] However, neither TILA nor its regulations require subprime lenders to offer their best, advertised terms to every customer. Indeed, the statute and the regulations do not even require lenders to provide disclaimers stating that availability depends on creditworthiness.[30]

(governing open-end home equity plans).

[29] 15 U.S.C. § 1662(2); 12 C.F.R. § 226.24(a); *cf. id.* § 226.16(a) (governing open-end credit).

[30] Congress also recently amended TILA to provide that when a lender advertises a loan in which the amount lent may exceed the fair market value of a principal residence that secures the loan (either in paper format or on the Internet), the lender must clearly and conspicuously state that the interest on any principal that exceeds the home's fair market value is not deductible for federal income tax purposes and advise consumers to consult a tax adviser. *See* 15 U.S.C.S. § 1664(e) (LexisNexis 2005); *see also id.* § 1638(a)(15), (b)(3); Truth in Lending, 70 Fed. Reg. 60,235, 60,244 (Fed. Reserve Sys., advance notice of proposed rulemaking, Oct. 17, 2005). This provision does not take effect, however, until twelve months after the date of publication of implementing regulations by the Federal Reserve Board. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,

Advertisements featuring low introductory rates on variable-rate loans--known as "teaser rates"--raise other difficulties that TILA fails to fully resolve. Under TILA, an advertisement touting a teaser rate must state how long the teaser rate lasts and advise readers that the APR could rise after consummation.[31] However, nothing in TILA requires an ad to describe the rate increase, its limits, or how it would affect the payment schedule.[32] This allows lenders to entice borrowers with promises of low interest without revealing how high their interest rate could eventually go.

Other aspects of TILA regulation weaken the effect of even these few restrictions on home loan advertisements. For instance, there are "no specific rules for the format of the necessary [advertising] disclosures."[33] While advertising under TILA is supposed to display information "clearly and

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Pub. L. No. 109-8, tit. XIII, § 1302(c), 119 Stat. 23, 209 (2005) (to be codified at 15 U.S.C. § 1637a note). As of November 19, 2006, no such regulations had yet been adopted.

[31] 15 U.S.C. § 1664(d); 12 C.F.R. § 226.24(c); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, §§ 226.17(c), 226.24(b) - (c).

[32] Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.24(c).

[33] *Id.* § 226.24.

conspicuously,"[34] the spirit of that standard is often honored in the breach. In fact, the Official Staff Interpretations of TILA's regulations advise that the "credit terms need not be printed in a certain type size nor need they appear in any particular place in the advertisement."[35] What is more, consumers cannot sue lenders or the publications that run their ads under TILA for advertising violations.[36] As a result, enforcement of TILA's advertising rules is weak or nonexistent.

In sum, TILA's provisions on mortgage advertising are silent on two key issues that affect truth in advertising for subprime loans. First, TILA

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[34] 15 U.S.C. § 1632(a).

[35] *Id.*; 12 C.F.R. § 226.17(a)(1); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.17(a); *cf.* 12 C.F.R. §§ 226.5(a)(1), 226.16(b) (governing open-end credit).

[36] *See, e.g.*, Jordan v. Montgomery Ward & Co., 442 F.2d 78, 81 (8th Cir. 1971) (finding that "it was the intent of Congress not to provide private civil relief for violations of the credit advertising provisions [of TILA]"), *cert. denied*, 404 U.S. 870 (1971); Fidelity Mortgage Corp. v. Seattle Times Co., 304 F. Supp. 2d 1270, 1273 - 74 (W.D. Wash. 2004) (holding that a party who does not rely on misleading advertisements does not have standing to sue under the credit advertising provisions of TILA); *see also* 15 U.S.C. §§ 1640(a), 1665 (describing the civil liability of creditors and the non-liability of advertising media).

allows subprime lenders to tout their best rates, without disclaimers and regardless of the fact that numerous subprime customers will not qualify for those rates. Second, TILA permits lenders to dangle alluring teaser rates before consumers without notifying them how high their interest rates might go following rate reset. Weak enforcement of TILA's few advertising provisions further increases the likelihood of misleading disclosures.

B. *Subsequent Disclosures*

When consumers shop for credit, they often inquire into the terms of specific loans. For the most part, however, TILA and RESPA do not regulate disclosures in response to these consumer inquiries at or before the application stage.[37] When a loan officer or broker takes an application, for instance, she will usually make representations to the customer about the nominal interest rate, the loan product (e.g., fixed, adjustable rate, hybrid, interest-

[37] The main exception concerns disclosures about variable-rate features, which on rare occasions require earlier disclosures under TILA. *See infra* notes 50 - 61 and accompanying text.

only), and the loan term (e.g., thirty years) by entering that information on the application form (Figure 1). These entries are not binding, however, under TILA or RESPA.[38] The lender is free, at least under these statutes, to change the loan product or the final terms of the loan for any reason after taking the loan application so long as the lender satisfies all subsequent disclosure requirements. Entries on the application form only become binding if the borrower and the lender privately negotiate a lock-in commitment, which is common in the prime market but not in the subprime market.[39]

After a consumer submits a loan application, TILA and RESPA impose disclosure requirements.[40] As

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[38] *See infra* notes 39 - 49, 62 - 65, 75 - 80 and accompanying text.

[39] See Brooke A. Brower, *On Focus: HUD Chief's RESPA Fix Looks Less Sure as Critics Multiply*, AM. BANKER, Mar. 3, 2003, at 1; *Q4 2004 Impac Mortgage Holdings, Inc. Earning Conference Call-Final*, FD (FAIR DISCLOSURE) WIRE, Feb. 15, 2005.

[40] These requirements of TILA are subject to criminal and civil government enforcement. *See* 15 U.S.C. §§ 1607, 1611. Willful and knowing violations are punishable by a fine of up to $5000 and imprisonment for up to one year. *Id.* § 1611. In addition, borrowers can sue for actual damages, statutory damages, and attorneys' fees--either individually or in class actions--for violations of TILA's loan-specific provisions. 15 U.S.C. § 1640(a).

In certain closed-end, cash-out refinance home

discussed below, the content of those disclosures and their timing vary depending on the loan product and the statute.

1. The Truth in Lending Act

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mortgages, borrowers can rescind their loan transactions for any reason within three business days following consummation of the loan or the delivery of correct TILA disclosures, whichever is later. 15 U.S.C. § 1635(a). At closing, lenders must provide such borrowers with written notice of the right to rescind under TILA. *Id.*; 12 C.F.R. §§ 226.5(a), 226.23(b). In addition, borrowers with closed-end, cash-out, home refinance loans who receive inaccurate material disclosures (or who never receive disclosures) concerning the APR, any variable-rate features, the finance charge, the amount financed, total payments, or the payment schedule, can rescind their mortgages for up to three years following consummation. 15 U.S.C. §§ 1602(u), 1635(e) - (f). *See generally* RENUART & KEEST, *supra* note 18, § 6.4.2.5. When a borrower qualifies for this extended right of rescission, the rescission period usually lasts until the sale of the property or three years after consummation of the loan, whichever is earlier. 15 U.S.C. § 1635(f). Furthermore, five states--Connecticut, Massachusetts, Maine, Oklahoma, and Wyoming--have adopted TILA as a matter of state law and thus have an exemption from the federal act. Therefore, if the laws of these states recognize the doctrine of recoupment, borrowers defending themselves against foreclosure or a collection suit can arguably rescind at any time, not just within three years. *See* RENUART & KEEST, *supra* note 18, §§ 2.6.1, 2.6.2, 6.2.10.

a. *In General*. Except for variable-rate disclosures, TILA does not require disclosures about loans that elicit consumer inquiries until sometime after application. At that point, TILA requires written disclosure of the APR, the amount financed, the finance charge, and certain other features of the loan (Figure 2).[41] The deadline for these disclosures depends on the loan type. For first-lien, closed-end purchase money mortgages (i.e., loans used to buy homes) that are governed by RESPA,[42] the lender

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[41] 15 U.S.C. § 1638(a)(2)(A), (a)(3) - (a)(4); 12 C.F.R. § 226.18(b) - (r); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.18. The required disclosures include, but are not limited to, descriptions of the payment schedule, any demand feature, the total sale price, the presence of a prepayment penalty, late fees, the security interest, and certain other fees. 15 U.S.C. § 1638(a)(5) - (a)(14), *amended by* Act of Apr. 20, 2005, 15 U.S.C.S. § 1638(a)(15) (LexisNexis 2005); 12 C.F.R. § 226.18. For loans not subject to RESPA, the lender must also provide a separate written itemization of the amount financed. 12 C.F.R. § 226.18(c)(1); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.18(c).

[42] 15 U.S.C. § 1638(b)(2); 12 C.F.R. § 226.2(a)(19), (a)(24); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.2(a)(24), *amended by* 63 Fed. Reg. 16,669 (Apr. 6, 1998). RESPA applies to "federally related mortgage loans," which include loans that have a federal nexus (defined broadly) and are secured by residential real estate designed principally for the occupancy of one to four families. 12 U.S.C. §§ 2602(1), 2603(a), 2604(a),

normally must deliver or mail good faith estimates of these TILA disclosures within three business days after receiving a written loan application.[43] For most closed-end refinance mortgages, however, a lender can postpone making TILA disclosures until any time "before the credit is extended,"[44] which the Federal Reserve Board construes to mean any time "before consummation."[45] Thus, for most refinance

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2605(a), 2607, 2608(a), 2609(a) - (c), 2610 (2000); 24 C.F.R. § 3500.5 (2005).

[43] 15 U.S.C. § 1638(b)(2); 12 C.F.R. §§ 226.17(c)(2), 226.19(a)(1); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.19(a)(1) - (a)(2). Alternatively, if the creditor determines within three days after receipt of a written application that the application will be turned down on the terms requested, no disclosures are necessary. Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.19(a)(1) - (4).

In the rare event that the borrower consummates the loan before the three-day period elapses, the lender must make the disclosures before consummation. 12 C.F.R. § 226.19(a)(1). This could occur, for example, if a lender or broker fraudulently induced a consumer to sign a loan note unknowingly before the three-day period expired.

[44] 15 U.S.C. § 1638(b)(1). High-cost, closed-end refinance home loans that are governed by the Home Ownership Equity and Protection Act ("HOEPA") are subject to more stringent timing requirements. *See infra* notes 66 - 72 and accompanying text.

[45] 12 C.F.R. § 226.17(b). The regulation defines "consummation" as "the time that a consumer becomes contractually obligated on a credit transaction" under state law. 12 C.F.R. § 226.2(a)(13); Official

mortgages, a lender can delay providing TILA disclosures until the closing, so long as the customer signs the TILA disclosures before signing the loan agreement. "Theoretically, at least, disclosures could be given one second or thirty days *before* consummation without violating this requirement."[46]

This loophole for refinance loans hobbles borrowers in the subprime market, where refinance loans have been rife with abuses.[47] Even for loans requiring disclosures within three business days after receipt of application, most borrowers do not receive TILA disclosures before paying their application fees.[48] These fees usually are nonrefundable and cost several hundred dollars.[49] Accordingly, unless a lender volunteers the information required by TILA before taking an

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Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.2(a)(13)-1.

[46] RENUART & KEEST, *supra* note 18, § 4.3.2.

[47] *See* Engel & McCoy, *supra* note 13, at 1263, 1275, 1279 n.104, 1282 n.118.

[48] See HUD-FED JOINT REPORT, *supra* note 23, at 39 - 42.

[49] *See, e.g.*, Stef Donev, Getting a Mortgage: Find the Best Loan (Sept. 13, 2006), http://mortgages.interest.com/content/articles/mortgage_story.asp?story_id=1000034867&ID=interest ("Most lenders charge a non-refundable application fee that can range from less than $250 to as much as $500.").

application, the customer must pay several hundred dollars in order to learn the price of the loan. Even then, under TILA, many refinance customers may not learn the price of the loan until closing.

The only time lenders must provide individual disclosures under TILA before customers pay application fees is for variable-rate disclosures. When a customer is considering a closed-end variable-rate loan[50] secured by her principal residence, the creditor must supply her with a generic government handbook that provides an overview of how adjustable-rate mortgages work.[51] The lender must also provide the customer with copious generic disclosures about every variable product in which the customer expresses an interest. These disclosures, among

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[50] This Article uses "variable-rate" and "adjustable-rate" interchangeably.

[51] BD. OF GOVERNORS OF THE FED. RESERVE SYS., CONSUMER HANDBOOK ON ADJUSTABLE RATE MORTGAGES (ARM) (2005), *available at* http://www.federalreserve.gov/Pubs/arms/armstext_cover2005.pdf (quirkily known as the "charm book," after its acronym). In an adjustable-rate mortgage "the interest rate changes periodically, usually in relation to an index, and payments may go up or down accordingly." *Id.* Alternatively, the lender may provide the borrower with a "suitable substitute" to the charm book. 12 C.F.R. § 226.19(b)(1); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.19(b)(1)-1.

other things, notify the customer that she has inquired about a variable-rate loan.[52] A creditor who deals directly with the customer must furnish these disclosures whenever it provides the application form or before the customer pays a nonrefundable fee, whichever is earlier.[53] When a creditor solicits a loan application by phone or through an intermediary agent or broker, however, it may deliver the disclosures or put them in the mail no later than three business days following receipt of the application.[54]

While the timing rules for variable-rate disclosures represent a modest improvement over the general disclosure rules, the content of those

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[52] 12 C.F.R. § 226.19(b) (containing disclosure rules for closed-end, variable-rate, home-secured loans with terms of over one year); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.19(b)(2); *cf.* 12 C.F.R. § 226.18(f).
[53] 12 C.F.R. § 226.19(b).
[54] *Id.* For discussion of when a mortgage broker qualifies as an "intermediary agent or broker" for purposes of this provision, see Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.19(b)-3. If a mortgage broker does sufficient business with the creditor, the broker no longer qualifies as an "intermediary agent or broker," thus requiring the creditor to treat all applications solicited by that broker as applications made directly to the creditor. *See id.*

disclosures do not. The disclosures, twelve in number, range from a generic explanation of the index and the margin to obscure disclosures about the potential payment shock once the interest rate resets.[55] These profuse and bewildering disclosures amount to information overload (see example at Figures 3a - 3c). Furthermore, some courts have construed TILA to deny statutory damages liability for failing to give the variable-rate disclosures.[56]

Perhaps as a consequence of this case law, which discourages compliance, one major consumer advocacy organization reported that "[f]ew of our clients ever get these initial disclosures."[57] Later, at the closing, the final relevant TILA disclosure simply states that "[y]our loan contains a variable-rate feature. Disclosures about the variable-rate feature have been provided to you earlier" (Figure 2). Consequently, if the creditor fails to deliver the

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[55] 12 C.F.R. § 226.19(b).

[56] *See, e.g.*, Baker v. Sunny Chevrolet, 349 F.3d 862 (6th Cir. 2003); Brown v. Payday Check Advance, Inc. 202 F.3d 987 (7th Cir. 2000); *see also* RENUART & KEEST, *supra* note 18, § 8.6.5.3.

[57] Letter from the Nat'l Consumer Law Ctr. to Vice Chairman Roger W. Ferguson, Jr., and Governors Susan Schmidt Bies, Donald L. Kohn, and Mark W. Olson of the Fed. Reserve Bd. 2 (Jan. 17, 2006) (on file with the author).

initial variable-rate disclosures, the consumer will receive no advance disclosures about the maximum payment, the maximum interest rate, or the index used.

The variable-rate disclosure of greatest importance to most consumers is the worst case payment scenario under the loan--i.e., how high their monthly principal and interest payments could go if the loan hits its interest rate cap. Presumably consumers would like to know the actual dollar amount of their highest possible monthly payment. Instead, TILA allows lenders to provide a hypothetical involving payment shock on a $10,000 mortgage and let the borrowers do the math (Figure 3c, ¶ 4).[58] Alternatively, lenders may provide a historical example, again based on a $10,000 mortgage, explaining how high the payments would have gone

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[58] *See* 12 C.F.R. § 226.19(b)(2)(viii)(B), (ix)(B) (stating that the lender may provide at its option the "maximum interest rate and payment for a $10,000 loan originated at the initial interest rate (index value plus margin, adjusted by the amount of any discount or premium) in effect as of an identified month and year for the loan program disclosure assuming the maximum periodic increases in rates and payments under the program," along with an "explanation of how the consumer may calculate the payments for the loan amount to be borrowed based on" the $10,000 hypothetical).

under the terms of that loan based on the historical high for the past fifteen years (Figure 4).[59] Lenders cling to the $10,000 hypotheticals, which are arcane in the extreme, precisely because many consumers, particularly vulnerable ones, cannot calculate the payment shock for variable-rate mortgages.[60] The $10,000 hypotheticals are so badly outdated that the *New York Times* recently advised borrowers with exotic adjustable-rate mortgages to figure out their maximum

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[59] *See* 12 C.F.R. § 226.19(b)(2)(viii)(A) (providing that the lender may alternatively disclose a "historical example, based on a $10,000 loan amount, illustrating how payments and the loan balance would have been affected by interest rate changes implemented according to the terms of the loan program disclosure"). Lenders must also explain how consumers can apply the historical example to calculate the maximum payment on their own loans. 12 C.F.R. § 226.19(b)(2)(ix)(A).

[60] A 2004 study by the Consumer Federation of America found that over one-third of all Americans surveyed who preferred ARMs could not estimate a hypothetical payment increase. The percentages were even worse for respondents who were young adults age eighteen to twenty-four (forty-six percent), Hispanics and blacks (forty-three percent), people with incomes under $25,000 (forty-four percent), and people without a high school degree (fifty percent). Press Release, Consumer Fed'n of Am., Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages (July 26, 2004), *available at* http://www.consumerfed.org/pdfs/072604_ARM_Survey_Release.pdf. *See also infra* notes 127 - 128 and accompanying text.

monthly payments by consulting "mortgage payment calculators on the Web"[61]--not their TILA disclosures.

If initial disclosures, whether variable-rate or otherwise, turn out to be inaccurate, TILA sometimes requires redisclosure. If the lender denies the original application and the consumer then amends it, the amendment is treated as a new application and the three-day period starts anew.[62] If a variable-rate feature is added to the loan, new disclosures are necessary, but only immediately before consummation.[63] Finally, if the actual APR at closing varies from the APR that was originally disclosed by more than one-eighth of one percent, usually the creditor must disclose the actual APR by the settlement or consummation.[64] These last two rules place applicants who lack lock-in commitments at the mercy of lenders, who can change the loan terms and even the loan

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[61] Damon Darlin, *Keep Eyes Fixed on Your Variable-Rate Mortgage*, N.Y. TIMES, July 15, 2006, at C1.
[62] Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.19(a)(1)-4.
[63] Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.17(f)-2. *See supra* notes 50 - 59 and accompanying text for the content of these disclosures.
[64] 15 U.S.C. § 1638(b)(2) (2000); 12 C.F.R. §§ 226.17(f), 226.19(a)(2), 226.22(a); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.17(f)-1(i)(A).

products behind the scenes and then spring the new loan terms on the borrowers at closing.[65]

b. *High-Cost Loans Governed by the Home Ownership and Equity Protection Act.* Under the Home Ownership and Equity Protection Act ("HOEPA"),[66] federal disclosure law imposes stricter disclosure requirements on certain high-cost residential mortgages. HOEPA applies to most high-cost, closed-end, refinance residential mortgages. HOEPA defines high-cost loans in two ways: (1) loans with APRs of at least eight percent over the yield on Treasury securities of comparable maturity for first-lien loans (or ten percent for subordinate-lien loans); or (2) loans with total points and fees exceeding eight percent of the total loan amount or $400 (indexed annually), whichever is greater.[67]

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[65] *See* HUD-FED JOINT REPORT, *supra* note 23, at 43; Renuart, supra note 3, at 483.

[66] Pub. L. 103-325, 108 Stat. 2190 (1994) (codified as amended in scattered sections of TILA, 15 U.S.C. §§ 1601 - 1667).

[67] 15 U.S.C. § 1602(w), (aa)(1) - (4); 12 C.F.R. § 226.32(a), (b)(1). HOEPA does not apply to high-cost reverse mortgages. 15 U.S.C. § 1602(aa)(1), (bb); 12 C.F.R. § 226.32(a)(2). The federal government has civil enforcement powers for violations of HOEPA. In addition, willful and knowing violations of HOEPA are subject to criminal prosecution. 15 U.S.C. § 1611;

These so-called "HOEPA loans" require added disclosures at least three days before closing.[68] The advance disclosures include the final APR, the amount of individual monthly payments, the amount of any balloon payment, the principal borrowed, and fees for any credit insurance or debt-cancellation policy.[69] Lenders must notify borrowers in writing that they could lose their homes upon default.[70] Similarly, borrowers must be advised that they do not have to accept the loans just because they submitted loan applications or received disclosures.[71] For variable-rate HOEPA loans, lenders must also advise borrowers that their interest rates and monthly payments could increase and provide them with their maximum monthly

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see discussion *supra* note 40. HOEPA affords borrowers the same private right of action available under TILA. 15 U.S.C. § 1640(a); *see supra* note 40. In addition to TILA's standard remedies, borrowers who recover under HOEPA have a right to special enhanced damages consisting of all finance charges and fees paid by the borrower, 15 U.S.C. § 1640(a)(4), plus expanded rights of rescission. 15 U.S.C. §§ 1635, 1639(j); 12 C.F.R. § 226.23(a)(3). *See generally* RENUART & KEEST, *supra* note 18, §§ 9.4.9, 9.6 (discussing remedies for HOEPA violations).

[68] 15 U.S.C. §§ 1601, 1602(aa), 1639(a) - (b).

[69] *Id.* § 1639(a)(2); 12 C.F.R. § 226.32(c).

[70] 15 U.S.C. § 1639(a)(1)(B).

[71] *Id.* § 1639(a)(1)(A).

payment if the loan becomes fully indexed.[72]

The disclosure requirements for HOEPA loans represent marginal improvement over TILA's woefully inadequate disclosures for refinance loans. However, HOEPA does not cover subprime purchase money mortgages.[73] As a result, and because HOEPA's triggers are set so high for refinance loans, HOEPA disclosures apply at most to five percent of subprime first-lien home loans.[74] In any case, it is doubtful that a three-day warning is enough to dissuade a cash-strapped borrower who is desperate enough to pay the stiff rates on HOEPA loans.

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[72] 15 U.S.C. § 1639(a)(2)(B); 12 C.F.R. § 226.32(c). *See generally* RENUART & KEEST, *supra* note 18, § 9 (discussing high-cost home equity loan protections). "The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate." Interagency Guidance on Nontraditional Mortgage Product Risks: Final Guidance, 71 Fed. Reg. 58,609, 58,614 n.5 (Dep't of the Treas. et al. Oct. 4, 2006). Lenders must also advise HOEPA borrowers in advance of the loan closing that the total amount borrowed may be substantially higher than the amount requested due to the financing of insurance, points, and fees. *See* Truth in Lending, 66 Fed. Reg. 65,604, 65,610 - 11 (Fed. Reserve Sys. Dec. 20, 2001) (codified at 12 C.F.R. § 226.32(c)(5)).

[73] *See* HUD-FED JOINT REPORT, *supra* note 23, app. D, at 1.

[74] *See* Truth in Lending, 66 Fed. Reg. at 65,606 - 10.

2. Real Estate Settlement Procedures Act

RESPA requires lenders who make federally related mortgage loans[75] to provide borrowers with disclosures about their closing costs at two different points in the mortgage process. First, within three business days after application, the lender or mortgage broker must provide an applicant with a good-faith estimate of the settlement costs ("GFE") (Figure 5) and certain other disclosures concerning settlement costs and servicing.[76] This three-day period usually coincides with the three-day period for TILA disclosures (which only applies to purchase money mortgages).[77] Because the GFE only contains limited pricing terms--those related to origination fees--and does not list, for example, the APR, the payment schedule, or the prepayment penalty, it does not remedy the lack of mandatory three-day TILA disclosures for most home refinance loans.[78]

Later, at the closing for all federally related

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[75] For the meaning of this term, see *supra* note 42.
[76] 12 U.S.C. §§ 2603 - 2605(a) (2000); 24 C.F.R. §§ 3500.6(a)(1), 3500.7, 3500.21(b) (2005); *id.* pt. 3500 app. C.
[77] *See* RENUART & KEEST, *supra* note 18, at 172 n.244.
[78] *See supra* notes 44 - 46 and accompanying text.

mortgage loans (including refinance loans and reverse mortgages), the settlement agent must furnish the borrower with a standardized form listing the actual settlement costs paid at closing, known as a HUD-1 settlement statement (Figure 6), plus an initial escrow statement.[79] Borrowers have the right to inspect the HUD-1 upon request the day before closing.[80] Like the GFE, the HUD-1 will only disclose origination costs, not the APR or certain other key disclosures mandated by TILA. Accordingly, lenders who extend home refinance loans (other than the limited set of HOEPA loans) do not have to disclose the APR until the closing.

Under RESPA, injured borrowers have little recourse for false disclosures except to petition HUD for government enforcement.[81] Specifically, borrowers cannot recover damages unless they can prove that lenders: (1) failed to inform them that their loans could be transferred;[82] (2) received illegal kickbacks

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[79] 24 C.F.R. § 3500.8; *id.* pt. 3500 app. A. The lender may also need to make servicing disclosures at closing. *Id.* § 3500.21(c); *id.* pt. 3500 app. MS-1.
[80] 24 C.F.R. § 3500.10(a).
[81] Agency enforcement authority for RESPA is vested in HUD. 12 U.S.C. §§ 2602(6), 2617(a).
[82] *Id.* § 2605(f) (authorizing actual damages, statutory damages, costs, and attorneys' fees).

as defined by RESPA;[83] or (3) steered them to title companies.[84] Lenders have no liability to borrowers under RESPA for errors in GFEs or HUD-1 settlement statements, thereby dampening their motives to ensure accuracy.[85]

RESPA's timing rules have the same faults as TILA's timing rules. Lenders do not have to provide GFEs until after consumers have paid a nonrefundable application fee and, while borrowers can request a HUD-1 the day before closing, nothing requires lenders to notify borrowers of that right and borrowers are generally ignorant of it.[86] Furthermore, GFEs may have scant resemblance to actual closing costs because lenders are allowed to provide meaningless estimated ranges and do not face suit for inaccurate GFEs.[87] This problem is of

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[83] *Id.* § 2607 (authorizing treble damages and attorneys' fees).
[84] *Id.* § 2608. The defendant is liable for up to three times the fee for the title insurance. *Id.* § 2608(b).
[85] *See* HUD-FED JOINT REPORT, *supra* note 23, at XIX, 21.
[86] *See id.* at 43.
[87] *See id.* at XI. In a survey of GFEs, one author concluded that numerous GFEs were off by "a fair amount" and that some borrowers received "large underestimates." Mark Shroder, *The Value of the Sunshine Cure: Efficacy of the RESPA Disclosure Strategy* 12 (HUD Working Paper, 2000) (on file with

particular concern in the subprime market, where settlement costs range from high to plainly exorbitant.[88] As a result, GFEs are not helpful to consumers for comparison-shopping.

In sum, federal disclosure laws are problematic for subprime mortgage customers in four key respects. First, federal law does not require accurate disclosures of the cost of subprime loans before a customer pays a nonrefundable application fee (except for certain variable-rate disclosures). Indeed, under TILA, subprime lenders may advertise their best rates, even if those rates only apply to sterling customers. Second, TILA's variable-rate disclosures are too complex and obscure the information that is most critical to consumers--their worst case payment scenario. Third, for most closed-end home refinance loans other than HOEPA loans, lenders can legally postpone making TILA disclosures on the APR and other key price terms until the closing. Lastly, binding cost disclosures are usually not required until closing (except for borrowers who have HOEPA loans or

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the author).

[88] *See, e.g.*, Engel & McCoy, *supra* note 13, at 1266 - 67 & n.30; Renuart, *supra* note 3, at 467, 475 - 76, 482; Shroder, *supra* note 87, at 14 - 15, tbl.4.

request their HUD-1s the day before closing), which means that lenders can change the loan terms at the eleventh hour with no advance notice to borrowers.

III. Consumer Search and Price Revelation: The Effect of Market Forces

As the previous discussion suggests, federal disclosure laws do not ensure that consumers get accurate information sufficiently early in the mortgage process to permit low-cost, meaningful comparison-shopping. To the extent that consumers do get timely, accurate information, it is due to market forces, not federal disclosure law.

A. *Search in the Prime Market*

In the prime market, pricing is highly competitive, lenders market mortgages as commodities, and the market results in roughly homogeneous prices. Prime customers know that identical mortgages[89] go for

[89] Of course, mortgages with identical terms (such as a 30-year fixed mortgage or a 2/28 hybrid adjustable-rate mortgage) may carry different interest rates depending on the number of points. Each of those

about the same price and that lenders with competitive rates will prominently advertise discounts. Consequently, consumers will gravitate toward lenders who post prices. Prime lenders know this, which gives them strong incentives to advertise accurate prices in order to attract customers. Today, it is easy to comparison-shop for prime mortgages on the Internet, where standardized price information abounds (Figure 7).

These market forces mean that consumers who shop in the prime market do not have to pay application fees in order to get price quotes. Lenders reveal prices for free. Furthermore, because prices are highly competitive and mortgages are commodities, lenders have to offer consumers an added bonus to get them to apply. This gives consumers leverage to negotiate lock-in commitments and insist on "buy downs" on prices, in the form of interest rate reductions in exchange for points or other fees (Figure 7).[90]

When TILA was enacted in 1968,[91] the prime market

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pricing structures is a separate product and should be advertised as such.

[90] *See supra* note 12 and accompanying text.

[91] Pub. L. No. 90-321, tit. I, 82 Stat. 146 (1968)

was the only conventional mortgage market. That was the market that TILA was designed for. There, market forces ensure that lenders reveal critical price terms--including interest rates, lock-in commitments, and points--upfront and for free. In tandem with those forces, TILA was designed to standardize voluntary price disclosures. TILA does this relatively effectively for consumers who are prime-eligible and shopping for prime loans.

To be sure, price revelation could stand improvement in the prime market. Problems with RESPA's timing rules and lack of private enforcement for GFEs make closing costs a continued problem. Hidden transaction costs can be substantial in residential loan transactions and can haunt customers at closing, whether they are in the prime or subprime market.[92] Furthermore, guaranteed closing cost packages are still uncommon even in the prime market, although some lenders do offer them (at least for settlement costs within the lender's control).[93] The

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(codified as amended at 15 U.S.C. §§ 1601 - 1693 (2000)).

[92] *See, e.g.*, Kenneth Harney, *Guaranteed Closing Costs Are Approaching*, DETROIT FREE PRESS, Oct. 9, 2005, at 2F.

[93] *See, e.g.*, Amerisave, Guaranteed Closing Costs in Writing, http://www.amerisave.com/why_amerisave/

prime market is sufficiently competitive and prime customers are sufficiently savvy that closing cost abuses are less of a problem than in the subprime market. Nevertheless, all home mortgage applicants--prime and subprime--pay too much because of lack of transparency in closing costs. This problem is especially severe with respect to yield spread premia,[94] which are a pernicious form of broker

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writingcosts.cfm (last visited Oct. 8, 2006); E-Loan, Guaranteed Closing Costs, http://www.eloan.com/s/show/guarantee (last visited Oct. 8, 2006); Harney, *supra* note 92, at 2F.

[94] A yield spread premium is a reward paid by a lender to a mortgage broker for persuading the borrower to pay a higher interest rate than the lowest interest rate that the lender would be willing to accept. As such, yield spread premia are *per se* anticompetitive and hurt consumer welfare. *See, e.g.*, DEP'TS OF THE TREASURY & HOUS. & URBAN DEV., CURBING PREDATORY HOME MORTGAGE LENDING 40 (2000), *available at* http://www.huduser.org/Publications/pdf/treasrpt.pdf (stating that consumer advocates believe yield spread premia encourage brokers to increase interest rates); *Predatory Mortgage Lending Practices: Hearing on Abusive Uses of Yield Spread Premia Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 56 (2002) (statement of Howell E. Jackson, Prof. of Law, Harvard Univ.) (concluding that yield spread premia "serve only to [benefit] mortgage brokers," not consumers, and levy "implicit interest rates [that] are absolutely outrageous"), *available at* http://banking.senate.gov/02_01hrg/010802/jackson.htm. *See generally* Howell E. Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums (Jan. 8, 2002) (unpublished

compensation, but it pervades closing costs across the board.

B. *Search in the Subprime Market*

Consumer search is entirely different in the subprime world, where market forces impede meaningful comparison-shopping. In the subprime market, the market conditions on which TILA was based--lock-in commitments and free and early price revelation--break down. Instead, subprime lenders do not reveal prices until consumers pay to play.

In risk-based pricing, a lender cannot determine the actual price for a loan until the customer reveals information about his or her creditworthiness.[95] Today, lenders use the loan application process for that purpose, even though there are other, cheaper ways to research a customer's creditworthiness. As a result, the subprime market requires a customer to apply for a loan, pay a nonrefundable application fee, and go

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manuscript), http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf (arguing that yield spread premia exploit less sophisticated borrowers).

[95] *See* HUD-FED JOINT REPORT, *supra* note 23, at 40.

through underwriting to learn the price. Even then, subprime lenders often do not reveal the true price until closing.

1. Lack of Firm Price Quotes Before Application

In the prime market, consumers are able to obtain firm price quotes without charge on interest rates, APR, and points, by consulting advertisements or price lists posted by lenders. In the subprime market, this is virtually impossible because pricing mechanisms are hidden and advertisements usually tout only the lender's best price.

In the subprime market, lenders use their own internal price lists (known as "rate sheets") to determine what price to charge a given borrower for a specific loan.[96] A subprime rate sheet is a grid containing different prices for a specific loan. (Figure 8). This information would be useful to consumers in shopping for loans. Consumers cannot get this information, however, because subprime lenders protect rate sheets as proprietary secrets and only share them with their employees and mortgage

[96] *See* White, *supra* note 15, at 509 - 12.

brokers (Figure 9, asterisk footnote).[97] Nothing in federal disclosure law prohibits withholding the information on rate sheets from consumers.

Consequently, to comparison-shop before the application stage in the subprime market, consumers must rely on general advertisements or oral representations by mortgage brokers or loan officers. Even though subprime lenders and brokers keep rate sheets secret, that does not hinder them from running advertisements with price quotes. Indeed, it is a common practice for them to quote their best price, whether or not the loan applicant qualifies for it and often without disclaimers.[98] In effect, this operates as an affirmative misstatement for consumers with weaker credit profiles and can induce them to apply for loans that turn out to be higher-priced at closing.

Some advertisements and websites that quote low rates cater specifically to subprime borrowers.

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[97] *See id.* (providing examples of subprime rate sheets).

[98] *See, e.g.*, Michael Hudson, *Popular Mortgage Web Site Under Scrutiny*, WALL ST. J., July 12, 2006, at D1 (describing a lawsuit against Bankrate.com for allegedly "allowing its website to become a haven for 'bait-and-switch' loan practices").

Figure 10, for instance, illustrates an Internet site that allowed consumers to shop for mortgages based on their personal credit score. Here, a search on July 4, 2006, for a thirty-year fixed-rate mortgage for a borrower with a weak credit score of 590[99] resulted in quotes ranging from 6.1% with 1.5 points to 6.5% with two points. That week, average rates on thirty-year fixed-rate mortgages were 6.78% with 0.5 points, meaning that the rates quoted on the website appeared to be prime rates.[100] Only if readers clicked on the

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[99] Generally, Fair Isaac Company ("FICO") scores below 660 are considered to be poorer quality, subprime credit scores. White, *supra* note 15, at 509 n.2. *See generally* ALLEN J. FISHBEIN & PATRICK WOODALL, CONSUMER FED'N OF AM., EXOTIC OR TOXIC? AN EXAMINATION OF THE NON-TRADITIONAL MORTGAGE MARKET FOR CONSUMERS AND LENDERS 25 - 26 (2006), *available at* http://www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf (discussing the distribution of borrower FICO scores for newly prevalent loan products).

[100] Freddie Mac, Weekly Primary Mortgage Market Survey (June 29, 2006), http://www.freddiemac.com/dlink/html/PMMS/display/PMMSOutputYr.jsp (last visited Oct. 8, 2006).

In general, subprime interest rates are at least 200 basis points--two percentage points--above prime rates for comparable products. *See* White, *supra* note 15, at 512 - 13. In contrast, assuming that the borrower takes out a $200,000 loan, the APR on the 6.1% loan with 1.5 points is 6.24% and on the 6.5% loan with 2 points is 6.691%, while the APR on the 6.78% loan with 0.5 points is 6.829% (assuming no other closing costs for the loan). This means that

link "More info" and scrolled down a long page would they find a disclaimer stating: "*Rate/APR and terms may vary based on the creditworthiness of the individual . . . .*"[101] Given this disclaimer, it is not clear why the website allowed consumers to type in low credit scores at all unless the website was designed to give the misleading impression that a borrower with a 590 credit score would in fact receive the quoted prime rates.

In sum, subprime borrowers who do not qualify for a lender's best rates do not have the ability to obtain firm quotes before they apply for loans. Making matters worse, consumers with weak credit are likely to be misled by advertising featuring low subprime rates unless they actually qualify for those rates.

2. Lack of Firm Price Quotes After Application

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the rates quoted on the website were probably better than prime rates.

[101] In the search, the link "more info" appeared at http://www.myfico.com/LoanCenter/Results.aspx?Fire=11&States=22&Markets=257&LoanTypes=4&LowerLimit=&UpperLimit=&Score=590 (last visited July 4, 2006). Clicking on the link led to the disclaimer. Subsequently, this website took down these pages and changed its search methodology.

With the exception of HOEPA loans, TILA and RESPA normally do not require firm price disclosures until the closing.[102] Neither statute regulates the price terms that a loan officer or broker may enter on the application form. Similarly, neither statute requires firm price terms to be disclosed within three business days after receipt of an application. Instead, if the disclosures on GFEs or preliminary TILA disclosures prove inaccurate, the only cure is accurate disclosure at the closing. By then, however, disclosure is too late. By the closing, the average customer is psychologically invested in the loan and has too much riding on it--such as purchasing a house or refinancing unmanageable debts--to walk away.[103]

Subprime lenders can take advantage of legally sanctioned late disclosures to turn the terms and prices of subprime loans into a moving target and thereby achieve monopolistic pricing. A lender or

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[102] *See supra* notes 37 - 49, 62 - 65, 75 - 88 and accompanying text.

[103] *See, e.g.*, Baher Azmy, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295, 351 - 52 (2005) (stating that on the day of the loan closing "a borrower has psychologically committed herself to the loan").

broker might direct a customer to apply for one type of loan at Price A--say, a fixed-rate loan--change the loan during underwriting to an adjustable-rate mortgage at Price B, and change the loan again at closing to something different, such as an interest-only adjustable-rate mortgage, at Price C. Not surprisingly, the final price is often higher than the original quoted price.

The moving target problem is even worse for refinance loans that are not governed by HOEPA. In these cases, lenders do not even need to provide three-day TILA disclosures and can wait until closing to make their first loan-specific disclosures about the loan's APR.[104] The case of Lucy Brown is instructive.[105] In 1998, Ms. Brown applied for a thirty-year fixed-rate refinance loan at a nominal interest rate of 10.75%. Her preliminary TILA disclosure stated an 11.013% APR and a finance charge of $189,903.90. The disclosure said that her loan had no variable rate feature or prepayment penalty. During underwriting, the lender rated Ms. Brown as an

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[104] *See supra* notes 44 - 46 and accompanying text.
[105] This information was reviewed confidentially by the author. The facts are real but the name has been changed to protect the identity of the borrower.

"A" grade borrower who presumably qualified for a prime-rate loan.

Nevertheless, with no advance notice, the lender presented Ms. Brown at closing with a high-fee variable-rate loan carrying a large prepayment penalty and an initial nominal interest rate of 11.25%. The final TILA disclosure, first presented to her at closing, revealed that her APR had risen 27.64% to 14.085% and her finance charge had jumped 38.56% to $263,133.60. If Ms. Brown had received a prime loan, it would have cost her far less: at the time, the average prime-rate fixed thirty-year home mortgage carried a nominal interest rate of 7.00% and one point. The mortgage broker's file on Ms. Brown contained four different loan applications, each for a fixed-rate loan on different terms. She only signed two of the applications and none was for the variable-rate loan she ultimately got.

Sometimes lenders have legitimate reasons to change the loan terms during underwriting. For instance, the lender may decide that the applicant could not qualify for the loan requested, either on the face of the application or because the application was incomplete and subsequent facts

revealed underwriting problems. Even legitimate reasons to change the loan terms, however, do not justify allowing lenders to wait until the closing to reveal the change in terms, as TILA and RESPA usually permit.

Other times, lenders and brokers have underhanded motives for switching the loan terms and springing them on the borrower at closing. For instance, behind the scenes, brokers may negotiate a yield spread premium in exchange for higher interest payments to the lender.[106] In Ms. Brown's case, the lender paid the broker a $2373 yield spread premium as a reward for increasing the interest rate on the loan from 10.75% to 11.25% and for changing the loan from a fixed-rate loan to a riskier adjustable-rate loan with a large prepayment penalty. Before the closing, the broker did not tell Ms. Brown that it would receive a large yield spread premium in exchange for driving up the cost of her loan. In Ms. Brown's case, the result was bait-and-switch.

Of course, if customers could negotiate lock-in commitments with subprime lenders, they could largely avoid the moving target problem. Subprime customers

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[106] *See supra* note 94 and accompanying text.

with weak credit, however, have reduced leverage to insist on those commitments because lenders know these customers have fewer options and cannot qualify for prime credit. Subprime customers, moreover, tend to be less well-educated and less sophisticated about the mortgage market.[107] Subprime lenders, knowing that that they can usually delay firm price quotes until closing under TILA and RESPA, have no legal compunction to offer lock-in commitments. This leaves subprime borrowers vulnerable to nasty surprises at closing.

3. Problems with Variable-Rate Disclosures

Variable-rate loans are now the dominant first-lien loan product in the subprime market.[108] Recently, two new types of adjustable-rate mortgages ("ARMs") have cropped up in the subprime market: interest-only ("I-O") ARMs and option ARMs. These

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[107] *See* Lax et al., *supra* note 14, at 544 - 56.
[108] *See, e.g.*, *id.* at 543; Roberto G. Quercia et al., *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments* 23, 29 - 30 (Center for Community Capitalism Working Paper, 2005), *available at* http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf.

mortgages present substantially greater risks of payment shock than traditional ARMs. This heightened risk, especially to subprime borrowers, underscores the urgency of reforming variable-rate TILA disclosures.

In I-O mortgages, borrowers only pay interest for an initial period lasting anywhere from six months to five years. Once the introductory period expires, the borrowers' payments go up, often substantially, for up to four distinct reasons. First, the loan begins to amortize and borrowers start paying principal as well as interest. Second, the principal payments are higher than they would be under a fully amortizing loan because there are fewer years left to pay off the principal. Thus, in a thirty-year I-O ARM with a three-year introductory period, the principal will normally be paid off in twenty-seven years, not thirty. Third, if interest rates are rising, the variable-rate on the loan will go up on the reset date. Finally, numerous I-O ARMs offer introductory teaser rates that are below the indexed rate. Accordingly, when the teaser rate expires and the rate resets, the interest rate could

jump higher than it would from an indexed rate.[109]

Option ARMs are cousins of I-O ARMs and potentially even riskier. During the introductory period for an option ARM, a borrower can choose among four payment options: accelerated amortization of principal (over fifteen years), normal amortization (over thirty years), interest-only payments, or a low minimum payment that does not even pay off the interest due that month.[110] If a borrower opts for the minimum payment--as do up to seventy percent of option ARM borrowers[111]--the unpaid interest will be

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[109] *See, e.g.*, CHRISTOPHER L. CAGAN, FIRST AM. REAL ESTATE SOLUTIONS, MORTGAGE PAYMENT RESET: THE RUMOR AND THE REALITY 17, 25 (2006), *available at* http://www.firstamres.com/pdf/MPR_White_Paper_FINAL.pdf (discussing the burden of higher payments when teaser rates reset); MICHAEL FRATANTONI ET AL., MORTGAGE BANKERS ASS'N, HOUSING AND MORTGAGE MARKETS: AN ANALYSIS 55 (2005), *available at* http://www.mortgagebankers.org/files/Bulletin/InternalResource/38151_MBA_Monograph_No1.pdf (describing I-O loan repayment); Jody Shenn, *ARM Lenders Prep for Wave Of Teaser-Rate Expirations*, AM. BANKER, Jan. 18, 2006, at 1, 11 (discussing the anticipated consequences of the first significant wave of ARM payment shock); Ruth Simon, *Home Rundown: A Look at the Pros and Cons of Different Types of Mortgages--and Which One May Be the Best for You Now*, WALL ST. J., Jan. 16, 2006, at R4 (informing readers about the drawbacks of I-O loans).

[110] *See* FISHBEIN & WOODALL, *supra* note 99, at 7; FRATANTONI ET AL., *supra* note 109, at 56.

[111] *See* FISHBEIN & WOODALL, *supra* note 99, at 7.

added to principal, causing the loan balance to grow.[112] This negative amortization makes the initial monthly payments enticing. Once the introductory period expires, however, the borrower must start making regular principal and interest payments for the remainder of the loan. Option ARMs present the same risks of payment shock as I-O ARMs, plus the risk that the principal may grow over time due to negative amortization, further increasing the eventual payments. Even before the introductory period expires, payments can also go up if negative amortization boosts the balance on the loan above a specified level, generally 110% to 125% of the original loan amount.[113] For all of these reasons, option ARMs "are the most likely" of all nontraditional mortgages "to default."[114]

Both types of loans have made inroads into the subprime market. By the third quarter of 2005, over one-quarter of new subprime loans were I-O loans.[115]

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[112] *See* FRATANTONI ET AL., *supra* note 109, at 56.
[113] When this happens, the loan "recasts." *See* Cagan, *supra* note 109, at 17; Simon, *supra* note 109, at R4.
[114] Cagan, *supra* note 109, at 29.
[115] Doug Duncan, Mortgage Bankers Ass'n, MBA Nonprime Conference 18 (May 22, 2006), http://www.mbaa.org/files/Conferences/2006/Non-Prime/MarketOutlook.ppt#397 (last visited Oct. 19, 2006).

Similarly, a recent study found that option ARM borrowers had "lower credit scores than borrowers overall" and often had subprime credit scores (usually defined as FICO scores below 660).[116] The same study found that African American and Latino borrowers were more likely to receive I-O and option ARMs than non-minority borrowers even after controlling for income, debt loads and credit scores.[117]

There are substantial reasons for concern about the payment shock associated with I-O and option ARMs, particularly for cash-strapped subprime borrowers. One industry commentator warned that when interest rates reset from teaser rates, monthly payments could double on both types of loans, placing the affected borrowers in financial jeopardy:

> It is important to note that a household facing a doubling of mortgage payments will be in difficulty, whether that increase is applied in a single month or in a series of

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In the first quarter of 2006, originations of I-O loans dropped thirty percent from the previous quarter but still remained substantial. Standard & Poor's, Sector Report Card: The Heat Is On For Subprime Mortgages 3 (July 10, 2006) (S&P Ratings Direct).

[116] *See* FISHBEIN & WOODALL, *supra* note 99, at 25 - 26; *see also* White, *supra* note 15, at 509 n.2.

[117] *See* FISHBEIN & WOODALL, *supra* note 99, at 22, 24.

> incremental steps spread over two years . . . . [A] loan with an initial [teaser] rate of 1 percent that resets to a market rate of 6.3 percent will experience a substantial increase in payments, all the more so if negative amortization has increased the total principal amount subject to interest. That type of loan will experience *reset payment sensitivity*. An option-payment loan with a minimum payment *below* that of a 1 percent loan will face even greater reset sensitivity.[118]

These dynamics can and do lead to increased subprime default rates. A recent Fannie Mae analysis of subprime ARMs that underwent rate reset and were originated between March 2003 and March 2004 found, for instance, that sixteen percent of the borrowers

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[118] Cagan, *supra* note 109, at 19 (emphasis in original); *see also id.* at 21, 25 (noting that when "[teaser-rate] loans finally adjust to fully-amortizing market-rate levels, the payments will have increased by more than fifty percent from their initial amounts. Often the payments will have doubled, or more than doubled."); Simon, *supra* note 109, at R8 ("If rates go up by two percentage points, monthly payments could nearly double."). While Cagan discounted the presence of teaser rates and thus of the severity of reset adjustments for subprime loans, Cagan, *supra* note 109, at 21, FitchRatings reported in 2006 that the "current environment" was of "deeply teased short-term subprime hybrid ARMs combined with an interest-only affordability feature." FitchRatings, Rating Subprime RMBS Backed By Interest-Only ARMs 1 (March 9, 2006), *available at* http://www.fitchratings.com.; *see also* Interagency Guidance on Nontraditional Mortgage Product Risks: Final Guidance, 71 Fed. Reg. 58,609, 58,613 - 14 (Dep't of the Treas. et al. Oct. 4, 2006).

had defaulted or were late making payments by mid 2006.[119]

The prevalence of I-O and option ARMs in the subprime market suggests that these loans are often underwritten for the wrong reason. Due to the potential for large payment shock, these products are best suited for borrowers who have large disposable incomes, receive bonuses, or expect their income to rise sharply during the introductory period.[120] None of these conditions normally holds for subprime borrowers. Rather, subprime borrowers usually take out these loans to minimize their monthly payments on large loan balances. Sometimes they do so to buy a

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[119] *See* Vikas Bajaj & Ron Nixon, *Variable Loans Help to Put Off Mortgage Pain*, N.Y. TIMES, July 23, 2006, at A21. Fitch Ratings estimates that thirty percent of all subprime loans will undergo rate reset in 2006 and another twenty-two percent in 2007, many of which are I-O ARMs. FitchRatings, *supra* note 118, at 13.

[120] *See* Cagan, *supra* note 109, at 17 (commenting that "[t]hese loans . . . may be useful to homeowners who anticipate substantial increases in their income (such as recent graduates from law school), and to those who have low incomes for most of the year but receive high lump sum payments from time to time (such as people who are self-employed or professionals who receive much of their income in the form of a yearly bonus)"); FRATANTONI ET AL., *supra* note 109, at 55 - 56 (describing the types of borrowers I-O loans were designed for); Simon, *supra* note 109, at R4.

larger house or refinance large debts. Other times, they do so to buy a starter home in regions where payments on a fixed-rate loan on a starter home would exceed their means.[121] This is particularly common in overheated coastal real estate markets such as California.[122] Many lenders approve these loans to subprime borrowers based solely on a household's ability to pay the initial monthly payments, not on the possible maximum payments.[123] As Fitch, a leading

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[121] *See* Cagan, *supra* note 109, at 14, 17 (observing that "many adjustable-rate mortgage borrowers . . . bought recently and stretched their financial abilities to acquire a home with a low down payment and a low monthly payment"); *see also* FRATANTONI ET AL., *supra* note 109, at 56, 58 (stating that some borrowers use I-O loans to "extend their purchase power as house prices have increased"); Ruth Simon, *Option ARMs Remain Popular In Spite of Risks*, WALL ST. J., Aug. 15, 2006, at A2 (stating that "borrowers seeking to lower their monthly payments have few other choices" than option ARMs).

[122] *See* FISHBEIN & WOODALL, *supra* note 99, at 4; FRATANTONI ET AL., *supra* note 109, at 50.

[123] *See* Shenn, *supra* note 109 (reporting that lending "standards loosened throughout 2004 and 2005, particularly through the increased use of 'stated' incomes, higher debt-to-income ratios, and low down payments"). In 2006, federal banking regulators issued an interagency guidance that requires federally insured depository institutions who make I-O and option ARM loans to "address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins." Interagency Guidance on Nontraditional Mortgage Product Risks: Final Guidance, 71 Fed. Reg. at

credit rating agency, has warned, however, when lenders qualify financially strapped borrowers for loans only "at the initial rate and IO payments," not the larger eventual payments, "payment shock is exacerbated."[124] When the loans reset and the payments go up, many of these borrowers will find that they can no longer afford the payments.[125] At that point, borrowers will either have to refinance (which likely will be difficult), sell their homes, or go into default. Fitch predicts that as "home prices stabilize and interest rates rise, . . . subprime IO delinquency rates [will] increase."[126]

Consequently, it is essential that all

58,613. The regulators issued the proposed guidance out of concern that these products "are now offered by more lenders to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgage loans and may not fully understand the associated risks." *Id.*

[124] FitchRatings, *supra* note 118, at 11.

[125] *See id.* at 10 - 11.

[126] *Id.* at 13; *see also* Interagency Guidance on Nontraditional Mortgage Product Risks: Final Guidance, 71 Fed. Reg. at 58,609, 58,616 (expressing concern that "interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers"); Simon, *supra* note 121, at A2 (describing a 2006 Credit Suisse Group report finding that "[o]ption ARMs are going into foreclosure an average of 10 months after the loan is made, earlier than for other types of loans").

borrowers, including subprime borrowers, understand the worst case payment scenario before they take out I-O and option ARMs. Current TILA disclosures--based on an unrealistic, hypothetical $10,000 loan--are impossible for most consumers to comprehend. Even a sophisticated borrower would need to locate the hypotheticals in the sea of variable-rate disclosures and take the time to do the math. Thus, it comes as no surprise that residential borrowers with adjustable-rate mortgages "appear to underestimate the amount . . . their interest rates can change."[127] "Borrowers with less income or education seem especially likely not to know their mortgage terms," making them "more vulnerable to an increase in interest rates."[128]

IV. WHAT TO DO?

For all of these reasons, federal mortgage disclosures break down in a world of risk-based

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[127] Brian Bucks & Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?* 2 (Fed. Reserve Bd. Working Paper, 2006), *available at* http://www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf; *see also supra* note 60.

[128] Bucks & Pence, *supra* note 127, at 26.

pricing. TILA and RESPA do not mandate reliable information for meaningful comparison-shopping in the subprime market before application and the subprime market does not provide it. In fact, TILA unwittingly countenances affirmative misrepresentations to subprime customers by permitting lenders to tout their best rates and nothing else. Similarly, in most cases, nothing in TILA or RESPA requires lenders to provide firm price disclosures until the date of closing. These problems are compounded for variable-rate loans because current variable-rate disclosures obscure what is most important to subprime borrowers--the worst payment case scenario. While revamped disclosures are not a panacea for price revelation problems in the subprime market, they are an important part of the solution.

A. *Counteracting False Subprime Advertising*

Currently, virtually all subprime ads that publicize rates only quote the best rates (and, for variable-rate loans, often these are teaser rates).[129]

[129] Assuming, that is, that the advertisement is

For everyone except customers who actually qualify for the advertised rates, these ads are patently misleading. If comparison-shopping is to be meaningful, it is critical to eliminate false advertising that is designed to lead consumers down the primrose path to higher, hidden prices. Concomitantly, improved oversight could help make subprime advertising a vehicle for accurate price revelation.

Achieving truth in subprime advertising requires four distinct measures. First, any lender who advertises an APR for a subprime product should be required to advertise the full range of APRs that it charges for that product. Immediately next to this price range, a warning needs to appear stating that customers with weak credit will not qualify for the best price. Second, both of these disclosures need to be prominent, in boldface, and in a large font.[130]

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truthful. Some subprime advertisements list low rates that the lender does not in fact offer. *See, e.g.*, Letter from Donald S. Clark, Fed. Trade Comm'n, to Jennifer L. Johnson, Bd. of Governors of the Fed. Reserve Sys. 2 - 4 (Sept. 14, 2006), *available at* http://www.ftc.gov/os/2006/09/docketop-1253commentfedreservehomeeqlendimagev.pdf.

[130] In December 2003, the Federal Reserve Board laudably proposed rules to standardize the meaning of the "clear and conspicuous" standard. *See* Truth in

Third, for ads marketing adjustable-rate mortgages, the text should conspicuously state the maximum APR cap for the highest-priced version of the loan to inform consumers of the worst case payment scenario. Finally, Congress should amend TILA and RESPA to provide a private right of action to borrowers who enter into detrimental loans in reliance on misleading subprime advertisements. The first three measures fall well within the regulatory authority of

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Lending, 68 Fed. Reg. 68,793 (Fed. Reserve Sys. proposed Dec. 10, 2003). In June 2004, under intense fire from lenders, the Board withdrew the proposed rule. Equal Credit Opportunity, Electronic Fund Transfers, Consumer Leasing, Truth in Lending, Truth in Savings, 69 Fed. Reg. 35,541 (Fed. Reserve Sys. June 25, 2004). The following year, in the bankruptcy reform law, Congress required the Board, in consultation with other federal banking regulators and the Federal Trade Commission, to promulgate new regulations on the meaning of the "clear and conspicuous" standard for open-end credit plans. For example, the disclosure requirements for credit card plans should result "in disclosures which are reasonably understandable and designed to call attention to the nature and significance of the information in the notice." Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, tit. XIII, § 1309, 119 Stat. 23, 213 (2005) (to be codified at 15 U.S.C. § 1637 note). The Board issued a second advance notice of proposed rulemaking on the topic in October 2005. Truth in Lending, 70 Fed. Reg. 60,235 (Fed. Reserve Sys., advance notice of proposed rulemaking, Oct. 17, 2005).

the Federal Reserve Board to interpret TILA.

B. *Providing Firm Price Quotes to Subprime Customers Before Application*

In an ideal world, subprime customers could get firm quotes for free without paying for a mortgage application and could then shop those quotes with other lenders. The wrinkle, of course, is that subprime customers have to reveal their creditworthiness before lenders can compute a price. Today, that is accomplished through the loan application process, complete with a large nonrefundable application fee. However, given the prevalence of rate sheets, automated credit scores, and automated underwriting, there is no reason why subprime customers should have to make costly formal applications in order to obtain firm price quotes.

The costs of subprime mortgages fall into two broad categories: price terms and closing costs.[131] Price terms include interest, points, origination fees, broker fees, yield spread premia, and

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[131] *See generally* HUD-FED JOINT REPORT, *supra* note 23, at 40 - 41.

prepayment penalties. Under risk-based pricing, these terms can be computed by consulting a lender's rate sheet and determining where customers fall on that rate sheet, depending on their credit scores and loan-to-value ratios. Alternatively, lenders who determine prices using more sophisticated automated underwriting systems could interview the customer for the key underwriting variables, enter those variables in the system, and obtain a price quote in seconds.[132] With the customer's permission, a lender can obtain the customer's credit report and credit scores online for no more than ten to fifteen dollars.[133] Similarly, the loan-to-value ratio can be estimated using the proposed down payment and the purchase price of the home.

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[132] For descriptions of automated underwriting for applicants with weak credit, see generally Susan Wharton Gates et al., *Automated Underwriting in Mortgage Lending: Good News for the Underserved?*, 13 HOUSING POL'Y DEBATE 369 (2002); Susan Wharton Gates et al., *Automated Underwriting: Friend or Foe to Low-Mod Households and Neighborhoods?* (Freddie Mac Working Paper, 2003); and John W. Straka, *A Shift in the Mortgage Landscape: The 1990s Move to Automated Credit Evaluations*, 11 J. HOUSING RES. 207 (2000).

[133] *See* HUD-FED JOINT REPORT, *supra* note 23, at 28 - 29, 39 - 42; Credit InfoCenter, What Do Credit Bureaus Charge for Credit Reports?, http://www.creditinfocenter.com/creditreports.reportcost.shtml (last visited Oct. 22, 2006).

Consequently, it is now feasible for lenders and brokers to provide firm, upfront price quotes to subprime customers at minimal cost. Indeed, HUD reached that conclusion in 1998, when it proposed requiring lenders and brokers to provide firm price quotes before application in exchange for giving lenders and brokers immunity from RESPA's anti-kickback provisions.[134] Eight years have elapsed

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[134] *See* HUD-FED JOINT REPORT, *supra* note 23, at 28 - 29, 39 - 42; Simplifying and Improving the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers, 67 Fed. Reg. 49,134 (Dep't of Hous. & Urban Dev. July 29, 2002) [hereinafter HUD Guaranteed Package Rule].

The anti-kickback provisions of section 8 of RESPA prohibit referral fees, fee splitting, and unearned fees in residential mortgage transactions. Real Estate Settlement Procedures Act § 8, 12 U.S.C. § 2607 (2000). When HUD originally proposed guaranteed closing cost packages, it recommended immunizing yield spread premia from section 8 as an inducement to the lending industry to embrace the proposal. *See* HUD-FED JOINT REPORT, *supra* note 23, at 22, 29 - 30; HUD Guaranteed Package Rule, *supra,* at 49160 - 61. The inducement did not work and, more importantly, is economically perverse. Provisions in TILA and RESPA that allow lenders to change most loan terms until the last minute promote anticompetitive practices by allowing lenders and brokers to negotiate yield spread premia in exchange for higher rates behind the scenes and then spring costlier loans on borrowers at closing. *See* Jackson, *supra* note 94, at 3; Jackson & Berry, *supra* note 94. Accordingly, any proposal for a guaranteed closing cost package should ban the use of yield spread

since then and automated underwriting systems have become prevalent in the subprime industry.[135] By now, there is no doubt that lenders and brokers have the technical capability to provide firm, written price quotes to subprime customers, if not for free, then for the cost of pulling the credit report. Lenders should be required to provide such quotes for all loans using risk-based pricing, according to a fee schedule regulated by law, instead of demanding large nonrefundable application fees in order to reveal prices.

Critics have argued that lenders cannot provide firm price quotes before verifying customer representations or entering into lock-in commitments.[136] While sometimes these are legitimate concerns, neither poses an insuperable bar. Price quotes are always contingent on verification in the prime market and the same would be true in the

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premia in exchange for higher interest rates, points, fees or prepayment penalties.

[135] According to FitchRatings, automated "compliance systems have become a critical component of the underwriting and quality control process" in the subprime residential mortgage industry. Press Release, FitchRatings, Fitch Revises RMBS Guidelines for Antipredatory Lending Laws (Feb. 23, 2005), *available at* http://www.fitchratings.com.

[136] *See* HUD-FED JOINT REPORT, *supra* note 23, at 40 - 41.

subprime market.[137] In the subprime context, moreover, the only information that requires verification on numerous rate sheets is the loan-to-value ratio (calculated from the down payment and the property value), because the credit history and score are available from a trusted third party online. In any event, the surge of low-documentation and no-documentation loans in the subprime market belies a strict need for many types of verification. And as for the issue of lock-in commitments, HUD proposed a satisfactory resolution of that issue in 1998:

> The [price term] 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 to, and commensurate with, changes in the financial markets.[138]

HUD's language similarly underscores the need for lenders to offer lock-in commitments as a standard option in the subprime market.

As for closing costs, the time has come to require legally binding quotes on guaranteed closing

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[137] *See id.* at 42.

[138] *Id.* In addition to interest rate and points, the lock-in commitment should also cover origination fees and prepayment penalties.

cost packages in advance of payment of a nonrefundable application fee.[139] This reform is long overdue in the prime market, but it takes on special urgency in the subprime market, where closing costs are substantially higher on average, relative to the amount financed, than in the prime market. Guaranteed packages would include numerous settlement costs associated with subprime mortgages, including fees for services provided by creditors and third-party vendors, plus official filing and recording fees. Examples of these costs include broker compensation and fees for appraisals, surveys, credit reports, underwriting, recording, legal representation, title insurance and title searches.[140]

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[139] HUD and the Federal Reserve Board advanced a similar proposal in 1998. *See id.* at 32 - 33. HUD formally proposed a guaranteed closing cost rule in 2002 but eventually put the proposal on the back burner due to industry and consumer group opposition. *See* HUD Guaranteed Package Rule, *supra* note 134; Semiannual Regulatory Agenda, 71 Fed. Reg. 22,733, 22,751 (Dep't of Hous. & Urban Dev. Apr. 24, 2006).

[140] *See* HUD-FED JOINT REPORT, *supra* note 23, at 23 - 25. Note that some cost items overlap the categories of prime terms and closing costs. The cost of homeowners' insurance and transfer taxes would be excluded from guaranteed closing cost packages because these items depend on consumer choices unrelated to the credit transaction. *See id.* at 24. For discussion of other operational issues in implementing guaranteed closing cost packages, see

Guaranteed packages would need to go hand-in-hand with firm price quotes to prevent lenders from undermining the closing cost quotes by increasing the price terms after the fact.[141] Lenders would continue to have to provide borrowers with HUD-1s at closing to permit borrowers to verify that guarantees were honored. Providing customers with guaranteed closing cost packages before application would enable them to comparison-shop intelligently for closing costs.

The Federal Reserve Board and HUD have full authority to accomplish firm price quotes through notice-and-comment rulemakings. TILA requires disclosures "before the credit is extended,"[142] which gives the Board ample latitude to require firm price term disclosures early in the shopping process. Similarly, HUD felt confident enough about its authority to mandate a guaranteed closing cost package under RESPA that it proposed a rule to that effect in 2002.[143] Thus, firm price quotes could be attained without additional congressional authorization.

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id. at 25 - 31.

[141] *See id.* at 22, 28 - 29.

[142] 15 U.S.C. § 1638(b)(1) (2000).

[143] *See* HUD Guaranteed Package Rule, *supra* note 134.

C. *Addressing the Moving Target Problem*

Requiring firm price quotes and guaranteed closing cost packages would go a long way toward addressing the moving target problem in the subprime market. It would not entirely eliminate the problem, however. The price quotes just proposed would be subject to verification and could be raised if the customer's creditworthiness turned out to be worse than originally portrayed. Similarly, lenders would have latitude, absent lock-in commitments, to increase price terms to account for interest rate movements. Accordingly, the need for verification and financial market movements create openings for the moving target problem and the potential for surprise price hikes at closing.

While the moving target problem cannot be wholly eliminated, it can be substantially constrained. First, the reasons for any price hike should be strictly regulated. Lenders should only be allowed to alter price quotes for three reasons: (1) good faith subsequent discoveries or events resulting in a downgrade of a customer's creditworthiness; (2) lower-than-expected appraisals affecting loan-to-

value ratios; and (3) prevailing interest rate movements after application (barring any lock-in commitment), and only on the condition that any price changes be commensurate. With respect to (1), lenders would be barred from raising prices with respect to information (such as prior delinquencies or bankruptcies) that was already available from the customer's online credit report on the date of the price quote. Furthermore, no price changes would be allowed that result from behind-the-scenes compensation negotiations for mortgage brokers, loan officers, or other lending personnel.

Second, if legitimate reasons did exist for price changes, only the nominal interest rate, discount points, or origination fees could be changed. The lender could not unilaterally change any closing costs (including yield spread premia if they were regrettably still permitted)[144] that were guaranteed in the closing cost package. Limiting price increases to the nominal interest rate, discount points, or origination fees would help promote transparency in pricing.

Lastly, lenders who raise price quotes should be

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[144] *See supra* note 94.

required to deliver to the affected borrowers written disclosures announcing any new nominal interest rate, points, origination fees, finance charge, and APR. These disclosures should be made no later than seven days before the closing.[145] In cases where the lender also changes the loan product (such as from a fixed-rate loan to an adjustable-rate loan), the new variable rate disclosures discussed in the next section would be required, where applicable. Delivery of such disclosures would be automatic and would not require a prior request by the borrower. The accuracy of all new disclosures and price terms should be legally binding on the lender and should entitle the borrower to damages if breached.[146] In addition, any unilateral change in terms at closing by the lender should entitle the borrower to a three-year right of rescission.[147]

All of these changes except the expanded right

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[145] Tolerances could be used to excuse lenders from redisclosure for minor changes in the APR. Tolerances of 1/8 of one basis point for regular transactions and 1/4 of one basis point for irregular transactions would be appropriate. *See supra* note 64 and accompanying text. Tolerances refer to margins "within the TILA's 'tolerance' for error". *See* RENUART & KEEST, *supra* note 18, § 4.6.3.2.1.

[146] *See* HUD-FED JOINT REPORT, *supra* note 23, at 44.

[147] *See supra* note 40.

of rescission under TILA could be jointly accomplished by HUD under RESPA and the Federal Reserve Board under TILA without additional congressional authority. Indeed, HUD embraced many of these changes in its proposed guaranteed closing cost package rule in 2002.[148]

D. *Fixing Variable-Rate Disclosures*

Currently, variable-rate disclosures under TILA must recite most of the individual moving parts that drive the worst case payment scenario, such as the index, the margin, reset dates, individual reset caps, and lifetime maximum and minimum interest caps (Figures 3a-3c). These drivers of the worst case payment scenario are also found in the loan note at closing. What most consumers care about, however, is not the moving parts, but how high their principal and interest payments could go if the loan becomes fully indexed (and becomes fully amortizing, in the case of I-O and option ARM loans).[149] Moreover, consumers want the actual worst case dollar figures

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[148] *See* HUD Guaranteed Package Rule, *supra* note 134.
[149] *See supra* notes 58 - 61, 109 - 114 and accompanying text.

for their own loans, not extrapolations from a $10,000 hypothetical. Today, automated programs make tailored disclosures such as these cheap and easy for lenders to provide.

Accordingly, variable-rate disclosures should be pared down and revised to contain just four things. First, these disclosures should make it unmistakably clear that the borrower has an adjustable-rate loan. Second, the disclosures should state the number of months or years until the first reset date and the maximum interest rate and monthly principal and interest payment on that date for the actual loan in question. Third, the disclosures should state the earliest date on which the loan could become fully indexed and the maximum interest rate and monthly payment on that date. Finally, the disclosures should state whether the loan will contain a prepayment penalty, and if so, the maximum dollar value of that penalty and how long it would last. The disclosures would look something like this:

> You have asked for information about a variable-rate loan. With this loan, your interest rate and monthly payments would likely increase over time.
>
> - In ***two years*** from the closing, your

principal and interest payments could rise as high as $1,950 per month and your annual percentage rate could rise as high as 9.5%.

- In ***six years*** from the closing, your principal and interest payments could rise as high as $2,572 per month and your annual percentage rate could rise as high as 14.00%. This is the highest your principal and interest payments could go under this loan.

Warning: If you pay off most or all of your loan within two years of the closing, you will have to pay your lender a penalty of as much as $9,000.

Lenders would have to provide these disclosures in writing along with the initial firm quotes (or, for prime loans, before provision of an application form or payment of a nonrefundable fee, whichever is earlier). In cases where the lender later changed the price terms or loan product for permissible reasons, it would need to make new, written variable-rate disclosures (where applicable) no less than seven days before closing.

No congressional authorization would be needed to make this change. The Federal Reserve Board has full authority under TILA to implement these

changes.[150]

CONCLUSION

Currently, the prime market and subprime markets are segmented. The prime market uses average-cost pricing and the subprime market uses risk-based pricing. But there is every reason to think that risk-based pricing will eventually pervade the prime market and lead to the demise of average-cost pricing. The residential mortgage market has already started down this road with the invention of the "A-" customer (with slightly weaker credit than the typical prime market borrower) and the "Alt-A" customer (who looks strong on paper, but provides little or no documentary support of income or employment). Eventually it is likely that we will have other shades of "A" borrowers, each of whom receives an individualized price.

Current federal mortgage disclosures have broken down in the face of risk-based pricing. This Article advances proposals to repair mortgage disclosures and, in the process, to make it truly possible to

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[150] *See* 15 U.S.C. § 1604(a), (d) (2000).

meaningfully comparison-shop for residential mortgages in a world of risk-based pricing.