

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580



Office of the Secretary

September 14, 2006

Jennifer L. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th and C Streets, N.W.
Washington, D.C. 20551

Re: Docket No. OP-1253

Dear Ms. Johnson:

The Federal Trade Commission ("Commission") appreciates the opportunity to comment on the Federal Reserve Board's ("Board") notice regarding the "Home Equity Lending Market."¹

The Commission has wide-ranging responsibilities regarding consumer financial issues for most nonbank segments of the economy, including mortgage lenders, brokers, and advertisers. The FTC enforces a number of federal laws governing home equity lending, including the Truth in Lending Act ("TILA") and the Home Ownership and Equity Protection Act ("HOEPA"), which amended TILA to address certain practices for high-cost home equity loans.² The Commission also enforces Section 5 of the Federal Trade Commission Act ("FTC Act"), which more generally prohibits unfair and deceptive acts and practices in the marketplace.³ In addition, the Commission conducts research on home mortgage lending and related topics, develops consumer and business education materials,⁴ responds to inquiries about these matters from consumers, industry, and the media, and works with other federal and state

¹ 71 Fed. Reg. 26,513 (May 5, 2006).

² The TILA is at 15 U.S.C. § 1601 *et seq.*

³ The FTC Act is at 15 U.S.C. § 41 *et seq.*

⁴ These materials on mortgage issues are available at the Commission's *For Consumers Credit* web page, at <http://www.ftc.gov/bcp/online/edcams/credit/coninfo.htm>, under the category *Mortgages & Your Home*. The web page includes consumer education materials such as "Home Equity Loans: Borrowers Beware," "High-Rate, High-Fee Loans (HOEPA/Section 32 Mortgages)," and "Reverse Mortgages: Get the Facts Before Cashing In On Your Home's Equity," <http://www.ftc.gov/bcp/online/pubs/homes/eqscams.pdf>, <http://www.ftc.gov/bcp/online/pubs/homes/32mortgs.pdf>, and <http://www.ftc.gov/bcp/online/pubs/homes/rms.pdf>.

law enforcement entities to protect consumers from unfair or deceptive mortgage lending and servicing practices.

The following comments are based on the Commission's consumer protection experience in the home equity market. First, we describe the unfair and deceptive practices uncovered in the Commission's law enforcement activities. Second, we discuss the key issues raised regarding alternative mortgage products in the Commission's recent public workshop on this subject, including both the advantages and risks these market innovations provide consumers. Finally, we discuss the importance of informed consumer choice at each stage of the mortgage lending process and the Commission's research into important, unanswered questions about how best to provide material information so that consumers can use it when making decisions.

I. UNFAIR AND DECEPTIVE PRACTICES IN THE MORTGAGE LENDING MARKET: THE COMMISSION'S LAW ENFORCEMENT ACTIVITIES

The Commission's law enforcement actions have targeted deception and other illegal practices in the mortgage market, focusing in particular on the subprime market. In recent years, the agency has brought 21 actions against companies and principals in the mortgage lending industry, involving companies large and small in various regions of the country.⁵ Several of these cases have resulted in large monetary judgments, with a total recovery of more than \$320 million in redress for consumers. These enforcement actions have targeted deceptive or unfair practices in all stages of mortgage lending – from advertising and marketing through loan servicing – by mortgage brokers, lenders, and loan servicers.

⁵ *FTC v. Mortgages Para Hispanos.Com Corp.*, No. 4:06-CV-00019 (E.D. Tex. filed Jan. 18, 2006); *FTC v. Ranney*, No. 04-F-1065 (D. Colo. 2005) (judgment against ind. def.), (D. Colo. 2004) (judgment against corp. defs.); *FTC v. Capital City Mortgage Corp.*, No. 1:98-CV-00237 (D.D.C. 2005) (stipulated order with relief defs.), (D.D.C. 2004) (consent decree with ind. def.); *FTC v. Chase Fin. Funding*, No. SACV 04-549 (C.D. Cal. filed May 12, 2004); *United States v. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. 2003); *FTC v. Diamond*, No. 02-C-5078 (N.D. Ill. 2003); *United States v. Mercantile Mortgage Co.*, No. 02-C-5079 (N.D. Ill. 2002); *FTC v. Associates First Capital Corp.*, No. 1:01-CV-00606 (N.D. Ga. 2002); *FTC v. First Alliance Mortgage Co.*, No. SA CV 00-964 (C.D. Cal. 2002); *United States v. Action Loan Co.*, No. 3:00CV-511-H (W.D. Ky. 2000); *FTC v. NuWest, Inc.*, C00-1197 (W.D. Wash. 2000); *United States v. Delta Funding Corp.*, No. CV-00-1872 (E.D.N.Y. 2000); *FTC v. Barry Cooper Prop.*, No. 99-07782 (C.D. Cal. 1999); *FTC v. Capitol Mortgage Corp.*, No. 2:99CV580 (D. Utah 1999); *FTC v. CLS Fin. Serv., Inc.*, No. 99-CV-1215 (W.D. Wash. 1999); *FTC v. Granite Mortgage, LLC*, No. 99-CV-289 (E.D. Ky. 1999); *FTC v. Interstate Res. Corp.*, No. 1:99-CV-5988 (S.D.N.Y. 1999); *FTC v. LAP Fin. Serv., Inc.*, No. 3:99-CV-496 (W.D. Ky. 1999); *FTC v. Wasatch Credit Corp.*, No. 99-CV-579 (D. Utah 1999); *In re First Plus Fin. Group, Inc.*, FTC Docket No. C-3984 (2000); *In re Fleet Fin., Inc.*, 128 F.T.C. 479 (1999).

A. Deceptive Advertising and Marketing Practices By Lenders and Brokers

Most of the Commission's lending cases have challenged deception in the advertising or marketing of loans, including deceptive written marketing materials and oral misrepresentations when consumers are shopping for a loan. In particular, the Commission has charged lenders with misrepresenting loan fees and failing to disclose other hidden charges. For example, the Commission's complaint against Associates First Capital Corporation and Associates Corporation of North America ("the Associates")⁶ alleged that the defendants aggressively solicited consumers into debt consolidation home equity loans through false and misleading statements about loan costs. The complaint also challenged as deceptive the Associates' practice of packing single-premium credit insurance into loans. The defendants paid \$215 million for consumer redress to settle the FTC complaint and an additional \$25 million to settle a concurrent class action.

The Associates matter highlighted the use of allegedly deceptive savings claims at the outset of the lending process, a practice challenged in several Commission cases.⁷ The Commission alleged that the Associates falsely represented that consumers would save money when consolidating their existing debts into a home equity loan with the Associates. In fact, according to the complaint, the Associates' savings claims did not take into account the loan fees and closing costs the company typically added to the consumer's loan principal. Further, the claims did not reveal that for certain Associates loans, consumers would still owe the entire principal amount in a balloon payment at the end of the loan term.⁸

In another case against a mortgage lender that alleges deceptive marketing, the Commission reached a settlement in March 2002 with First Alliance Mortgage Co. ("FAMCO"). The Commission's complaint, which was consolidated with actions by six states, AARP, and private plaintiffs, charged that FAMCO's loan officers made deceptive claims in their sales presentations about fees and other loan terms.⁹ For example, FAMCO representatives allegedly promised consumers that the loans contained no upfront fees, when in fact they imposed origination fees that were typically 10 percent of the loan amount and sometimes as high as 20 percent. The final order barred the defendants from making misrepresentations about credit offers, required the corporate defendants to pay an amount equal to virtually all the corporate assets, and required FAMCO's founder and chief executive officer to pay an additional \$20 million. The Commission ultimately obtained redress totaling \$67 million for nearly 20,000 consumers.

⁶ See *FTC v. Associates*.

⁷ See also *FTC v. Chase Fin. Funding*; *FTC v. First Alliance Mortgage*.

⁸ *FTC v. Associates*.

⁹ *FTC v. First Alliance Mortgage Co.*

Mortgage brokers are now the primary originators of residential mortgage loans, commanding between 65-70% of the market.¹⁰ The Commission has brought enforcement actions against several mortgage brokers charged with deceiving consumers about key loan terms, such as the existence of a prepayment penalty¹¹ or a large “balloon” payment due at the end of the loan.¹² Similarly, the Commission has charged brokers with falsely promising consumers low fixed payments and rates on their mortgage loans.¹³ For example, the Commission has challenged deceptive advertising of a “payment option” adjustable rate mortgage.¹⁴ In June 2004, the Commission sued Chase Financial Funding (“CFF”), a California mortgage broker, and its principals, in connection with sending unsolicited emails and direct mail promising a “3.5% fixed payment loan.” The Commission alleged that CFF did not offer any such loan – the loan CFF falsely advertised was actually a “payment option” adjustable rate mortgage where interest accrued at a higher rate, where the principal balance would increase if consumers made payments at the advertised rates, and where payments were not “fixed.”

This year, the Commission filed suit against a mortgage brokerage company that it alleged deceived Hispanic consumers who sought to refinance their homes. The Commission’s complaint alleged that the broker misrepresented key loan terms, including the monthly payment amount, interest rate, annual percentage rate, finance charge, repayment term, and/or the amount of cash to be disbursed to the borrower out of the loan proceeds.¹⁵ The alleged conduct was particularly egregious because the lender conducted business with his clients almost entirely in Spanish, and then provided at closing loan documents in English that contained the less favorable terms.

B. Unfair and Deceptive Mortgage Loan Servicing

The Commission has challenged deceptive and unfair practices in the servicing of mortgage loans, including failing to post consumers’ payments upon receipt, charging for unneeded insurance, and charging other unauthorized fees. For example, in November 2003, the Commission, along with HUD, announced a settlement with Fairbanks Capital Corp. and its parent company.¹⁶ Fairbanks had been one of the country’s largest third-party subprime loan

¹⁰ See “New Research About Mortgage Brokers Published” (July 28, 2005), and other data, available at <http://www.wholesaleaccess.com>.

¹¹ *FTC v. Chase Fin. Funding*.

¹² *FTC v. Mercantile Mortgage Co.*; *FTC v. Diamond*.

¹³ *FTC v. Chase Fin. Funding*; *FTC v. Ranney*.

¹⁴ *FTC v. Chase Fin. Funding*.

¹⁵ *FTC v. Mortgages Para Hispanos.Com Corp.*

¹⁶ *United States v. Fairbanks Capital Corp.*

servicers – it did not originate any loans, but collected and processed payments on behalf of the holders of the mortgage notes. The Commission alleged that Fairbanks received consumers’ payments on time, but failed to post them until after the payment deadline had expired, and then imposed late fees and other charges as a result. It also challenged Fairbanks’ alleged practice of charging for homeowners’ insurance even though the borrowers already had insurance in place. The Commission further alleged that Fairbanks charged to those borrowers whom it deemed were in default numerous fees that were not authorized by the mortgage contract or by state law, or that were based on services never performed. And, the complaint charged Fairbanks with violating federal laws in using dishonest or abusive tactics to collect debts, and in reporting to credit bureaus consumer payment information that it knew was inaccurate. As a result of the settlement, Fairbanks paid \$40 million in consumer redress.¹⁷ Fairbanks also agreed to halt the alleged illegal practices and implement significant changes to its business practices to prevent future violations.

Unfair and deceptive loan servicing practices also came to light in the Commission’s lengthy litigation against Capital City Mortgage Corp. (“Capital City”), which both originated and serviced subprime mortgage loans.¹⁸ The Commission alleged Capital City targeted consumers with fixed or low incomes with offers for loans based on the equity in their homes, rather than on the borrowers’ creditworthiness. According to the Commission’s complaint, Capital City included phony charges in monthly statements, added phony charges to loan balances, forced consumers to make monthly payments for the entire loan amount while withholding some loan proceeds, foreclosed on borrowers who were in compliance with the terms of their loans, and failed to release liens on borrowers’ homes after the loans were paid off. A settlement, reached in February 2005, permanently enjoined the defendants from future deception, required them to pay consumer redress and other monetary relief, and required them to post a \$350,000 performance bond to remain in the lending business.¹⁹

II. ALTERNATIVE MORTGAGE PRODUCTS: THE COMMISSION’S PUBLIC WORKSHOP ON ALTERNATIVE MORTGAGES

The home mortgage marketplace has evolved rapidly in recent years in response to rising home prices and growing consumer demand for mortgage products other than the traditional, 30-year, fixed-rate, amortizing loans or adjustable rate mortgages (“ARMs”), where the borrower pays principal and interest each month for the life of the loan. The new demand has engendered a wave of new mortgage products, some of which offer consumers considerable financial benefits, but some that also pose substantial financial risk.

¹⁷ The Commission charged Fairbanks’ former CEO with similar law violations, and he agreed to a settlement with the FTC and HUD requiring \$400,000 in consumer redress.

¹⁸ *FTC v. Capital City Mortgage Corp.*

¹⁹ *Id.*

In May 2006, to explore the financial benefits and risks of new mortgage products, the Commission sponsored a day-long public workshop, *Protecting Consumers in the New Mortgage Marketplace* (the “Workshop”).²⁰ The Commission frequently sponsors public workshops such as this, in addition to its investigatory and law enforcement efforts, to learn more about new or changing areas in the marketplace and to obtain input on policy issues presented by those changes. The Commission generally then places the workshop transcripts on the public record. The transcript of this Workshop is available at the Office of the Secretary to the Commission or at <http://www.ftc.gov/bcp/workshops/mortgage/transcript.pdf>.²¹

The Workshop focused primarily on the two types of alternative mortgage products that have experienced the greatest growth in popularity and market share in the past two years: interest-only (“I/O”) loans and payment option adjustable rate mortgages (“payment option ARMs” or “option ARMs”).²² Workshop participants also briefly discussed other non-traditional loan products, including fixed-rate I/O loans, 40-year fixed-rate mortgages, and 50-year hybrid ARMs.²³ Additionally, the Workshop addressed the pending Interagency Guidance on Nontraditional Mortgage Products.²⁴ Workshop panelists included industry representatives, consumer advocates, federal and state regulators, and academic and market authorities.

A. Alternative Mortgage Products: I/O and Option ARM Loans

1. Interest-Only Loans

According to the Workshop record, the most prevalent alternative mortgage product today is the I/O loan,²⁵ which commanded a more-than-25% share of the mortgage market in 2005, up sharply from less than 2% of the market in 2000.²⁶ I/O loans provide for an initial loan period

²⁰ See 71 Fed. Reg. 15,417 (Mar. 28, 2006) and <http://www.ftc.gov/bcp/workshops/mortgage/index.html>.

²¹ This Comment cites the Workshop transcript as “Tr.” followed by the applicable transcript page numbers. This Comment also cites handouts that panelists distributed at the Workshop by the panelist’s name, followed by the page or other appropriate reference. They are available by panelist name at <http://www.ftc.gov/bcp/workshops/mortgage/index.html>.

²² See, e.g., Cutts Handout, slide 8.

²³ See, e.g., Tr. 23-24.

²⁴ See generally Tr. 118-141. The proposed Interagency Guidance is found at 70 Fed. Reg. 77,249 (Dec. 29, 2005). See also 71 Fed. Reg. 9,339 (Feb. 23, 2006).

²⁵ See generally Tr. 16-19, 36-40, 69-74, on I/O loans.

²⁶ Tr. 16. In regions that have experienced especially elevated home price growth, the popularity of I/O loans has climbed even higher, constituting as much as 60% of new

during which borrowers pay only the interest that is accruing on the loan balance. When the initial period expires, the borrower's payments expand to pay both principal and interest. Because the payments during the introductory period are not amortizing, they are smaller than the payments in a traditional amortizing loan. Particularly popular are hybrid-rate I/O loans, which carry a fixed interest rate for an introductory period, generally one to ten years, and then become variable-rate loans for the remainder of the loan's term.²⁷

2. Payment Option ARMs

Payment option ARM loans²⁸ also have experienced a rapid growth in popularity in recent years. Option ARMs are different than traditional ARMs in that they generally offer borrowers four choices about how much they will pay each month during the loan's introductory period. Borrowers may pay: (1) a minimum payment amount that is smaller than the amount of interest accruing on the principal; (2) the amount of interest accruing on the loan principal; (3) the amount of principal and interest due to fully amortize the loan on a 15-year payment schedule; or (4) the amount of principal and interest due to fully amortize the loan on a 30-year payment schedule.

Option ARMs vary in the length of the introductory periods they offer. Some, especially in the subprime market, have introductory periods of only one year, six months, or even one month.²⁹ When the loan's introductory term expires, the loan is recast,³⁰ amortizing to repay principal and the variable interest rate over the remaining term of the loan.

B. Alternative Mortgage Products: Benefits and Risks

The new mortgage products offer significant benefits for many consumers but also may pose substantial risks. As discussed below, some of the benefits and risks of the new products are unique to those products. In addition, there are some risks that are common to traditional and alternative mortgage products, but may be greater for holders of alternative mortgage loans.

mortgage originations. *See, e.g.*, Cutts Handout, slide 9; McBride Handout, slide 3; Tr. 33.

²⁷ Unless otherwise specified, all subsequent references to I/O loan products within this Comment refer to hybrid-rate I/O loans.

²⁸ *See generally* Tr. 19-22, 29-31, 36-40, 69-74, 78-85, on payment option ARM loans.

²⁹ *See, e.g.*, Tr. 30-31, 152, 218, 241.

³⁰ Sometimes loan recasting occurs early, as discussed on pages 8-9, *infra*. Option ARMs may be recast periodically, *e.g.*, every five years, for the remainder of the loan's term.

1. Unique Benefits and Risks of Alternative Mortgage Products

Workshop participants agreed that I/O and option ARM mortgages are similar in the benefits they offer and the risks they carry. The magnitude of these benefits and risks vary based on borrower characteristics and market conditions, but may be more extreme on both scales for consumers with alternative loans as compared to traditional mortgage products.³¹

According to Workshop participants, by offering consumers the option of making lower required payments in the early years of a loan, the alternative loans make it easier, initially, to purchase a home, or to purchase a more expensive home than a consumer might otherwise buy at that time. The alternative loans also may be very useful for certain groups of consumers. These include consumers who work on commission or for other reasons have variable incomes: they can pay more when they earn more, and pay less when they earn less. Other beneficiaries may be affluent or financially sophisticated consumers, such as investors who can earn a higher rate of return on the money they would otherwise use to make larger, fixed-rate mortgage payments.³² Additionally, borrowers who are confident they will sell or refinance their homes for an equal or increased value before the introductory period of the loan expires may benefit from alternative loan options. Also, upwardly mobile borrowers who can reasonably expect to have higher incomes by the end of the initial loan repayment period likely benefit from alternative mortgage products.³³

According to Workshop participants, other consumers, however, may not be good candidates for alternative loans.³⁴ According to Workshop panelists, consumers who hold alternative I/O or option ARM loans can see their minimum payment requirements as much as double when the introductory period ends.³⁵ Three factors contribute to this sudden upswing. First, borrowers who pay interest only during the introductory period must begin repaying both principal and interest when the introductory period ends, and must amortize the principal within a shorter time span than in a traditional 30-year loan, resulting in higher payments. Second, if the loan was offered with a special low “teaser” rate that has now expired, a higher, “fully-indexed”

³¹ For benefits of nontraditional mortgages, *see generally* Tr. 16-17, 19-21, 64-66, 70, 81; McCoy Handout, slide 2.

³² *See, e.g.*, Tr. 65-66, 81 (borrowers using the extra pocket cash from alternative rate mortgages to invest in employer-matched 401K programs, or make other investments with estimated higher yield than housing appreciation).

³³ *See, e.g.*, Tr. 16-17, 19-20, 70; McCoy Handout, slide 2.

³⁴ *See generally, e.g.*, Tr. 17-22, 70-74, and accompanying McCoy Handout, on risks of nontraditional loans.

³⁵ *See* Tr. 18-22, 70-71.

interest rate based on the current market takes effect.³⁶ Third, even if there is no teaser rate, if interest rates have risen during the introductory period, the interest portion of the monthly payment will now increase. The result for consumers who see their monthly minimum payment requirements skyrocket at the end of the introductory period is often termed “payment shock.” Thus, Workshop panelists concluded, consumers who may have trouble paying the minimum monthly payments during the introductory period and have few economic resources or no reason to expect a rise in income when the introductory period ends may risk financial hardship, refinancing costs, and/or loan default once payment shock sets in.

Finally, according to Workshop participants, there are some circumstances in which “payment shock” in an option ARM loan may occur prior to the expiration of the loan’s introductory period. Generally, when a consumer has made only the minimum payment, the loan “negatively amortizes,” so that the amount the person owes is increased by the difference between the interest accruing and the minimum amount paid. This can result in heftier monthly payments down the road.³⁷ However, if the consumer frequently pays the minimum payment option, the unpaid loan balance may grow so large that it triggers a “negative amortization cap” – often from 110% to 125% of the initial loan principal amount.³⁸ When the cap is reached before the end of the introductory period, the loan is recast and amortized to repay principal and interest within the remaining period of the loan, thereby substantially increasing the consumer’s monthly payments.³⁹ Several panelists commented that for some consumers this may pose a grave risk,⁴⁰ because they may even owe more than the home is worth. In such situations, refinance and resale options may be unattractive or unavailable, and the consumer at some point could default and eventually lose the home.⁴¹

2. Common Mortgage Risks that are Heightened for Alternative Loans

With any mortgage, whether a traditional or alternative product, consumers can find themselves in financial straits for any number of reasons. Unexpected health-care costs or loss of a job are the top two reasons why consumers may suddenly find themselves unable to meet their

³⁶ The fully-indexed rate of an ARM is the then-current value of its index (*e.g.*, LIBOR, Treasury, COFI), plus any additional percentage points (known as the margin) that the lender adds to the index. *See generally, e.g.*, Tr. 78.

³⁷ *See, e.g.*, Tr. 19-22.

³⁸ *See, e.g.*, Tr. 31, 80, 114.

³⁹ *See, e.g.*, Tr. 80-81.

⁴⁰ *See, e.g.*, Tr. 21, 72-73, 89-90, 127-130, 218-219.

⁴¹ *See, e.g.*, Tr. 72-73.

monthly mortgage obligations.⁴² Certain loan practices, borrower features, and market shifts, however, can have a greater adverse financial impact for some holders of alternative mortgage loans than traditional mortgage loans.

Risk Layering. “Risk layering” means relaxing more than one of the traditional underwriting standards, which potentially increases the risk of a loan default.⁴³ Panelists discussed how a lender could add additional risk onto a nontraditional loan product in a number of different ways.⁴⁴ For example, the lender could issue the nontraditional loan to a borrower with little or no initial down payment or equity, creating a high loan-to-value ratio. Depending on market conditions, some borrowers in these circumstances may have no cushions of equity in their homes when their required loan payments increase, potentially making it more difficult for them to refinance their mortgages or cover the costs of selling their homes.⁴⁵ Or, risks may increase when a lender does not require a nontraditional loan borrower to thoroughly document income or assets, a practice commonly referred to as making “low-doc” or “no-doc” loans.⁴⁶ Panelists also suggested risk layering occurs when lenders offering alternative mortgages issue simultaneous second-lien mortgages known as “piggyback” loans.⁴⁷ Additionally, some panelists argued, a lender may increase risk by lending to subprime borrowers, characterized as such because of their low credit scores.⁴⁸ Such risk layering can exacerbate the risks of alternative mortgage loans, including the risk of default. Accordingly, many Workshop panelists cautioned against risk layering unless countervailing positive loan features mitigate the risks.⁴⁹

⁴² Tr. 55-56; Cutts Handout, slide 11.

⁴³ *See generally, e.g.*, Tr. 22-23, 128.

⁴⁴ *See* Tr. 128.

⁴⁵ Panelists opined that equity in one’s home might serve as a cushion permitting home sale, refinance, or conversion of stored equity to cash. *See* Tr. 40, 48-50. In recent years, borrowers have tended to make lower down payments when purchasing homes. Workshop participants reported that last year, 42% of first-time home buyers did not make any down payment. Tr. 22, 40.

⁴⁶ *See, e.g.*, 130-131.

⁴⁷ A piggyback loan is an additional mortgage that a borrower obtains at the same time as the primary mortgage to buy or refinance the same home, increasing the home’s overall loan-to-value ratio. Often the secondary loan is an I/O home equity loan or another kind of ARM. *See, e.g.*, Tr. 23, 128-129.

⁴⁸ *See generally, e.g.*, Tr. 22-23, 70-74, 128, 131.

⁴⁹ For example, low loan-to-value ratios may help mitigate layering risks. Tr. 130-131.

Market Shifts. Panelists also noted that holders of alternative mortgage loans may be especially subject to financial jeopardy caused by certain market shifts.⁵⁰ Risk-enhancing market shifts include rising interest rates, which affect holders of variable rate mortgages because their payment obligations rise with the interest rates. Similarly, a borrower with an alternative mortgage who planned to sell or refinance his or her home at the close of the introductory period to avoid the higher payments could be hit especially hard if regional home prices were flat or declining.⁵¹

Consumer Features. Panelists further noted that consumers who assume an alternative mortgage based on their current ability to afford its low introductory rates, without regard to their future ability to make the higher, post-introductory period payments, may be at considerable risk of future default.⁵² This risk may be exacerbated for consumers who are on a fixed income.

C. Alternative Mortgages' Consumer Protection Issues

Beyond discussing the products and their costs and benefits, the Workshop panelists focused primarily on two consumer protection questions: whether consumers receive information about the terms of nontraditional mortgage products that is sufficient and timely; and, whether lenders should consider as part of their underwriting process the appropriateness of an alternative mortgage product for the consumer applying for the loan.

1. Loan Term Disclosure Issues

Workshop panelists agreed that to make informed decisions about mortgage loans, consumers need clear information explaining their mortgage options. Panelists differed, however, about whether consumers are getting such information, and whether the disclosure timetable that the TILA establishes provides for early enough disclosure of critical loan terms.⁵³

Some panelists suggested that brokers and lenders should explain loan product terms at the marketing or shopping phase of a consumer's mortgage acquisition process, not just, as the TILA requires, at the application phase or before closing.⁵⁴ Moreover, some panelists argued that

⁵⁰ See generally Tr. 17-18, 21-23, 34-39, 56-57, 70-74, 129, 204.

⁵¹ Of course, a decline in property values may harm all property owners, and not just those with alternative products, but the Workshop focused only on alternative mortgage products.

⁵² See, e.g., Tr. 17-22, 70-74.

⁵³ See, e.g., Tr. 62-63, 75-76, 88-89, 91, 94-95, 95, 111-117, 123-125, 170, 171, 180-181, 243-244, 248, 258-260, 279.

⁵⁴ For proponents of earlier risk disclosures, see Tr. 88-91, 95, 95-96, 138, 184, 264-265; see also Tr. 117; 266-267 (arguing self-interested lenders face a "dilemma" because early disclosure of product risks might "scare away some borrowers"). For TILA disclosure timing

lenders should provide consumers in the shopping phase with payment schedules tailored to the consumers' individual loan needs. Contrary to the general information currently mandated under Regulation Z at the application phase,⁵⁵ such schedules would show for each loan product more specific information on the amount by which the principal and interest will increase, assuming no change in interest rates, when the loan is recast.⁵⁶ Providing this information at the earlier stages would balance the short-term benefits derived from low initial payments – often represented in the advertising and marketing stage – with a fair understanding of the long-term risks of payment shock.

Moreover, the panelists agreed that disclosures at every stage need to be provided in a clear (“plain English”), concise manner so that consumers can understand them.⁵⁷ Several panelists discussed the fact that the written disclosures required by the TILA (such as at the

requirements prior to the loan, *see* 12 C.F.R. §§ 226.17(b), 226.18, and 226.19(a) and (b). *See also* Tr. 108-117.

Some panelists suggested that brokers should have a fiduciary responsibility to prospective borrowers. *See* Tr. 252-256. Other panelists disagreed; for example, one panelist commented that in view of brokers' contracts with lenders, it would create a conflict of interest if brokers had a fiduciary responsibility to borrowers. *See* Tr. 193.

⁵⁵ Regulation Z currently requires lenders to provide general information at the application phase for most ARMs. First, they must provide the Board's Consumer Handbook on Adjustable Rate Mortgages (commonly known as the CHARM booklet) or substantially similar information. 12 C.F.R. § 226.19(b). In addition, they must provide other loan disclosures focusing on the type of loan in which the consumer is interested, but all of the information is not tailored to the consumer's expected loan terms. For example, one disclosure provides an example of a loan in the amount of \$10,000, with instructions advising consumers to calculate their potential loan terms based on the \$10,000 template. *See* 12 C.F.R. § 226.19(b)(2)(viii). However, loan amounts today far exceed \$10,000, and it is unclear if many consumers can “do the math” to adapt the examples in the disclosure to the loan terms they are considering. *See, e.g.,* Tr. 75-76.

⁵⁶ *See, e.g.,* Tr. 75-76, 95, 241-242 (sample web site payment calculator), 244, 283-284; *see also, e.g.,* Tr. 185. *See also* Tr. 241-242, 262-263 (sample calculations with varying assumptions about the behavior of interest rates over the term of a loan).

⁵⁷ *See* Tr., 75-76 and accompanying McCoy Handout, 94-95 (“plain English” 1-page condensed disclosure), 184, 241-242, 260-261; *see also* Tr., 171, 205-206, 243-244, 258-260. Several panelists also commented that many consumers may want an easy way to calculate potential scenarios they may face for an alternative mortgage product they are considering. *See, e.g.,* Tr. 115, 191, 213-14, 240-44. In addition, a Workshop panelist discussing education issues noted that educational materials also should be “very easy to comprehend.” *See* Tr. 244.

application phase or before closing) often are presented in a dense, complex document that is difficult to read and understand.⁵⁸

2. Loan Underwriting Issues

Workshop panelists differed on the issue of lenders' responsibility in the underwriting of alternative mortgage loans. Some panelists recommended that lenders be required to qualify a borrower based on the borrower's ability to repay the loan at the fully-indexed rate.⁵⁹ For loans that allow negative amortization, these panelists said, the analysis should assume the borrower will make only minimum required payments, and evaluate the ability to repay the resulting increase in the loan balance.⁶⁰ Other panelists disagreed, suggesting that consumers should be free to make their own decisions about accessing credit, provided they have adequate information to make informed decisions. These panelists argued that the fully indexed rate standard may deny informed consumers access to credit, improperly shifting to the lender the responsibility for making the consumer's credit choices.⁶¹ Some panelists also suggested that the secondary market provides sufficient market oversight for any risks that alternative mortgage products pose.⁶² Others countered that the secondary market and other industry players can diversify their risks, whereas individual consumers cannot.⁶³

III. INFORMED CONSUMER CHOICE IN THE MORTGAGE MARKETPLACE

For many consumers, one of the most important financial decisions they make is choosing a mortgage loan. Shopping for a mortgage loan and choosing the right loan can be a daunting process because it is not a product most consumers shop for very often, and it can be difficult to obtain and compare information about the costs and terms of different mortgage products.

⁵⁸ See, e.g., Tr. 75-76 and accompanying McCoy Handout, 111-117, 170, 183, 184.

⁵⁹ Tr. 73, 76, 78-79, 126-130, 139-140, 178-179, 201.

⁶⁰ Tr. 126-130; see also Tr. 213-214, 218-219.

⁶¹ See Tr. 205-206, 208, 212, 216-217; see also, e.g., Tr. 127 (alleging some lenders conduct underwriting based on borrower's ability to make initial stream of low payments).

⁶² See Tr. 96-97, 190, 216-217, 220. For example, *The Washington Post* recently reported that Standard & Poor's Corp. ("S&P"), the most influential ratings agency in the mortgage arena, has changed its policy on piggyback loans. As of July 1st, S&P requires lenders selling piggyback loans into secondary mortgage market bond pools to purchase substantial additional credit enhancements that provide additional protection for bond investors against higher expected mortgage default rates. Kenneth R. Harney, *Piggybacking Onto Trouble*, Wash. Post, July 8, 2006, at F1.

⁶³ See Tr. 53-54, 99-100, 126-130, 169-170, 178; cf. 171-172 (risk apportioned among industry, regulators and borrowers, but borrowers unavoidably bear risk of losing home).

Moreover, for loans with more complexity – such as nontraditional mortgages – consumers face further challenges in understanding all significant terms and costs. It is therefore critical that consumers obtain all of the relevant information they need to make an informed choice at each stage of the process.⁶⁴ As the Commission’s law enforcement experience shows, some lenders and brokers take advantage of the complexity of mortgage loans and deceive consumers about the terms of the loans. Ensuring that consumers have the information they need about loan terms can help consumers protect themselves from deception.

The Commission’s law enforcement experience indicates that deceptive advertising claims and oral misrepresentations made during the marketing phase can mislead the consumer even if the consumer ultimately receives completed Truth in Lending and other disclosures at closing.⁶⁵ These principles are particularly important to apply to alternative mortgage products so that consumers are not misled about what type of loan is being offered.

As consumers continue the process of shopping for a mortgage, it is important that they receive timely and understandable information about terms and costs of the particular products they are trying to analyze and compare. As noted by several panelists at the recent workshop, the loan closing may be too late for many consumers to obtain this information.⁶⁶ Moreover, for many nontraditional mortgage products – where the payment schedule likely will increase substantially in future years – it is important that consumers receive information about their payments at a time when they can readily use that material in selecting their preferred loan and terms.

Providing mortgage information at the time of closing is also vital to consumers’ informed use of credit. The current TILA and Regulation Z framework is intended to provide consumers with this important opportunity to review, understand, and agree to the offered loan terms.⁶⁷ However, in the Commission’s law enforcement experience, and further supported by

⁶⁴ Congress cited these concerns as the fundamental underpinning of the TILA. “It is the purpose of this title to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available . . . and avoid the uninformed use of credit . . .” 15 U.S.C. § 1601(a).

⁶⁵ The Commission and courts long have held that an entity violates Section 5 of the FTC Act if it induces the first contact through deception, even if it provides disclosures before the consumer enters the contract. *Resort Car Rental Sys., Inc. v. FTC*, 518 F.2d 962, 964 (9th Cir. 1975); *see also FTC v. Minuteman Press*, 53 F. Supp. 2d 248, 262-63 (E.D.N.Y. 1998) (“common-sense net impression” controls a conflict between a mandatory written disclosure and an oral representation).

⁶⁶ For example, in refinancings, consumers receive certain TILA disclosures about the costs and terms of their loans “before” consummation – which usually occurs at closing. *See* 12 C.F.R. § 226.17(b), and 226.18.

⁶⁷ *See* 12 C.F.R. § 226.18.

the workshop discussions, even when presented, the disclosures may be dense, difficult to understand, and laden with technical terms, such as “negative amortization.” It is not clear to what extent consumers may understand such terms or whether other language might be preferable.

How and when to make disclosures effective so that consumers can understand the terms can best be determined through consumer research.⁶⁸ The Commission’s Bureau of Economics (“BE”) is currently concluding a mortgage lending disclosure study that will provide further guidance on these questions.⁶⁹ The BE study is examining: 1) how consumers search for and choose a mortgage; 2) how they use and understand information about their mortgages (including required disclosures); and 3) whether improved disclosures might enhance consumers’ understanding, mortgage shopping, and ability to avoid deception.⁷⁰ When the study is completed, the BE staff will publish a report with its findings on how required disclosures and other information impact consumers’ ability to understand mortgage costs and features in both prime and subprime mortgage markets. The Commission will share this report with you when it is released.

⁶⁸ See “The Effect of Mortgage Compensation Disclosures on Consumers and Competition: A Controlled Experiment,” Federal Trade Commission Bureau of Economics Staff Report, by James M. Lacko and Janis K. Pappalardo (Feb. 2004). See also “The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment . . . or Why Disclosures are Tricky,” presented by James M. Lacko and Janis K. Pappalardo, FTC Bureau of Economics at “Reflecting on Thirty-five Years of Consumer Disclosure Regulation” at Georgetown University Credit Research Center, Washington, D.C. (Oct. 5, 2004). Janis K. Pappalardo, FTC Bureau of Economics, also presented the latter paper at the Board’s home equity hearing in Atlanta, Georgia, on July 11, 2006.

⁶⁹ See 70 Fed. Reg. 820 (Jan. 5, 2005); 69 Fed. Reg. 57,932 (Sept. 28, 2004); 68 Fed. Reg. 47,566 (Aug. 11, 2003); and 68 Fed. Reg. 19,825 (Apr. 22, 2003). The BE study was initiated in view of the fact that mortgage disclosure requirements (such as under the TILA and the Real Estate Settlement Procedures Act (“RESPA”), 12 U.S.C. § 2602) and various proposals for change have been advanced for many years, yet little empirical evidence exists about how the disclosures impact consumer understanding of mortgage terms, shopping behavior, and mortgage choices. Issues related to providing effective mortgage disclosures were also addressed by the Board and the Department of Housing and Urban Development in their *Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act* (July 1998).

⁷⁰ See 70 Fed. Reg. at 821 (Jan. 5, 2005).

IV. CONCLUSION

The Commission appreciates your consideration of its views. If any other information would be useful regarding these matters, please contact Peggy Twohig, Associate Director for Financial Practices, at (202) 326-3224.

By direction of the Commission.

Donald S. Clark
Secretary