

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. 06-12]

FEDERAL RESERVE SYSTEM

[Docket No. OP-1267]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[No. 2006-36]

NATIONAL CREDIT UNION ADMINISTRATION

Illustrations of Consumer Information for Nontraditional Mortgage Products

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA) (collectively, the Agencies).

ACTION: Final guidance – Illustrations of Consumer Information for Nontraditional Mortgage Products.

SUMMARY: The Agencies are publishing three documents that set forth Illustrations of Consumer Information for Nontraditional Mortgage Products. The illustrations are intended to assist institutions in implementing the consumer protection portion of the Interagency Guidance on Nontraditional Mortgage Product Risks (Interagency NTM Guidance) adopted on October 4, 2006. 71 FR 58609 (Oct. 4, 2006). The illustrations are not model forms and institutions may choose not to use them in providing information to consumers on nontraditional mortgage products as recommended in the Interagency NTM Guidance.

EFFECTIVE DATE: [Insert date of publication in Federal Register].

FOR FURTHER INFORMATION CONTACT:

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FDIC: April Breslaw, Acting Associate Director, Compliance Policy & Exam Support Branch, Division of Supervision and Consumer Protection, (202) 898-6609; or Richard Foley, Counsel, Legal Division, (202) 898-3784.

OTS: Montrice G. Yakimov, Assistant Managing Director, Compliance and Consumer Protection Division, (202) 906-6173; or Glenn Gimble, Senior Project Manager, Compliance and Consumer Protection Division, (202) 906-7158.

NCUA: Cory Phariss, Program Officer, Examination and Insurance, (703) 518-6618.

SUPPLEMENTARY INFORMATION:

I. Background

On December 29, 2005, the Agencies published the Interagency NTM Guidance for comment. 70 FR 77249 (Dec. 29, 2005). After carefully reviewing and considering all comments received, the Agencies published the Interagency NTM Guidance (applicable to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions) in final form on October 4, 2006. 71 FR 58609 (Oct. 4, 2006).

The Interagency NTM Guidance sets forth recommended practices to ensure that consumers have clear and balanced information about nontraditional mortgages prior to making a mortgage product choice, such as when lenders provide promotional materials about nontraditional mortgages or during face-to-face meetings when consumers are shopping for a mortgage. The guidance also recommends that any monthly statements given with payment option adjustable rate mortgages (ARMs) provide information to enable consumers to make informed payment choices.

Several commenters on the proposed guidance, including industry trade associations, encouraged the Agencies to include model or sample disclosures or other descriptive materials as part of the Interagency NTM Guidance. In response, the Agencies determined that illustrations of consumer information would be useful to institutions as they seek to implement the consumer information recommendations. Therefore, on the same day the Interagency NTM Guidance was published in the Federal Register, the Agencies published for comment proposed Illustrations of

Consumer Information for Nontraditional Mortgage Products (Proposed Illustrations). 71 FR 58673 (Oct. 4, 2006).

The three Proposed Illustrations consisted of (1) a narrative explanation of nontraditional mortgage products, (2) a chart comparing interest only (IO) loans and payment option ARMs to fixed rate and traditional adjustable rate loans, and (3) a table that could be included with any monthly statement for a payment option ARM providing information on the impact of various payment options on the loan balance. The Agencies noted that there would be no Agency requirement or expectation that institutions use the illustrations in their communications with consumers. Instead, the Agencies intended to illustrate the type of information that the Interagency NTM Guidance contemplates. Institutions would be able to determine whether or not to use the illustrations and whether and how to tailor them to their own circumstances.

The Agencies requested comment on all aspects of the Proposed Illustrations. Specifically, they requested commenters to address whether the illustrations, as proposed, would be useful to institutions, including community banks, seeking to implement the “Communications with Consumers” portion of the Interagency NTM Guidance, or whether changes should be made. The Agencies also encouraged specific comment on whether the illustrations, as proposed, would be useful in promoting consumer understanding of the risks and material terms of nontraditional mortgage products, as described in the Interagency NTM Guidance, or whether changes should be made. Finally, the Agencies sought comment on whether other illustrations relating to nontraditional mortgages, in addition to those proposed, would be useful to institutions and consumers.

After considering the comments received, the Agencies are now issuing final illustrations of consumer information for nontraditional mortgage products. The Interagency NTM Guidance

recommends that promotional materials and other product descriptions provide consumers with information about the costs, terms, features, and risks of nontraditional mortgage products that can assist consumers in their product selection decisions. This includes information about potential payment shock and negative amortization and, where applicable, information about prepayment penalties and the costs of reduced documentation loans.

Institutions seeking to follow the recommendations set forth in the Interagency NTM Guidance may, at their option, elect to:

- Use the illustrations;
- Provide information based on the illustrations, but expand, abbreviate, or otherwise tailor any information in the illustrations as appropriate to reflect, for example:
 - the institution's product offerings, such as by deleting information about loan products and loan terms not offered by the institution and by revising the illustrations to reflect specific terms currently offered by the institution;
 - the consumer's particular loan requirements;
 - current market conditions, such as by changing the loan amounts, interest rates, and corresponding payment amounts to reflect current local market circumstances;
 - other information, consistent with the Interagency NTM Guidance, such as the payment and loan balance information for statements discussed in connection with Illustration No. 3 or information about when a prepayment penalty may be imposed; and
 - the results of consumer testing of such forms; or

- Provide the information described in the Interagency NTM Guidance, as appropriate, in an alternate format.

To assist institutions that wish to use the illustrations, the Agencies will be posting each of the illustrations on their respective websites in a form that can be downloaded and printed for easy reproduction. In addition, in response to concerns that the interest rates used in Illustration No. 2 may become outdated with changes in market interest rates – and consistent with the Agencies’ intention, expressed above, that the illustrations may be modified to reflect, among other things, current market conditions – the Agencies also will be posting on their respective websites a template that can be used by institutions that wish to modify the information presented in Illustration No. 2 to reflect more current interest rates (and corresponding payment amounts). Illustration No. 2 itself reflects typical interest rates for prime borrowers in today’s environment, rounded to the nearest whole number to enhance simplicity.¹

II. Overview of the Comments

Collectively, the Agencies received letters from over 30 commenters on the proposal, including comments from two financial institutions, 12 consumer advocates and community organizations, 12 trade organizations, two individuals, and three state regulatory organizations.

Most commenters generally approved of the illustrations and expressed appreciation for the Agencies’ efforts to demonstrate ways lenders could advance the consumer communication goals outlined in the Interagency NTM Guidance. Generally, commenters stated that the proposed illustrations would be useful to financial institutions – including community banks –

¹ Illustration No. 2 also embodies assumptions about other product features that are typical in the current market: for example, the illustration assumes that the payment option ARM provides for a cap on increases in the minimum monthly payment equal to 7.5 percent per year for the first 5 years of the loan. Thus, the illustration shows the minimum monthly payment increasing over this time period from \$739 (in Year 1) to \$987 (in Year 5).

seeking to develop their own disclosures to help consumers understand the risks of nontraditional mortgage products. Commenters also suggested that the illustrations provided helpful guidance on the Agencies' expectations and would help reduce implementation costs.

Most financial institutions and trade organizations supported the voluntary nature of the illustrations. These commenters stated that the flexibility afforded them by the Agencies would allow them to convey information to their customers in a format most suited to customers' needs. Additionally, having the flexibility to develop their own disclosures would allow financial institutions to tailor their disclosures to take into account specific product offerings and market conditions.

However, a smaller group of commenters that included 8 consumer groups and one industry group disagreed, and suggested that consumer education efforts should be mandatory. The trade group noted that providing for voluntary use of the illustrations makes unclear the degree to which the illustrations will be used, when they will be used, and how they will assist consumers. This commenter suggested that the Agencies propose model forms and provide lenders with a safe harbor when they use the model forms.

Several financial institutions, trade organizations, and community organizations suggested that the illustrations should be made part of the Board's revisions to Regulation Z, which implements the Truth in Lending Act. These commenters suggested that making the illustrations part of Regulation Z would ensure more widespread industry use. Additionally, some commenters expressed concern that issuing guidance on consumer information materials applicable only to federally-supervised institutions would put those institutions at a competitive disadvantage. The Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators (AARMR), and the National Association of Consumer Credit

Administrators (NACCA) commented that they believe the illustrations also could be used by state-licensed entities subject to state-issued guidance that parallels the Interagency NTM Guidance.

A number of commenters expressed concern that the illustrations were difficult to follow and would be confusing to consumers, and should be simplified. A few industry trade groups and a consumer group advised the Agencies to engage in consumer testing or hire consultants to determine how to improve the illustrations. A number of commenters provided very specific suggestions aimed at making the illustrations easier to understand. Several industry commenters requested that the Agencies add language explaining how a consumer could benefit from nontraditional mortgage products. Further, one trade organization stated that lenders should be able to implement the consumer information recommendations of the Interagency NTM Guidance by providing consumers with the interagency publication titled, “Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?”²

Finally, two commenters suggested that the Agencies include in these illustrations information about two additional products – 2/28 and 3/27 adjustable rate mortgages. These are “hybrid” ARMs that start with a fixed interest rate for two or three years, respectively, and then reset to a variable rate, which generally will be higher than the introductory fixed rate. Because the Interagency NTM Guidance does not cover fully-amortizing mortgage products such as hybrid ARMs, the Agencies are not including information on these products in the NTM illustrations. However, when the Agencies finalize the “Statement on Subprime Mortgage Lending,” which was proposed on March 8, 2007, and which provides guidance concerning

² “Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?” *available at:* http://www.federalreserve.gov/pubs/mortgage_interestonly/mortgage_interestonly.pdf.

hybrid ARM products, we expect to issue for public comment disclosure illustrations appropriate for that guidance.³

III. Final Illustrations

After carefully considering all of the comments received, the Agencies have decided to publish the proposed illustrations, with some modifications. The Agencies have determined that illustrations of the type of information contemplated in the Interagency NTM Guidance are needed now. Additionally, the Agencies believe that issuing the materials as nonmandatory illustrations will provide institutions with the flexibility needed to tailor the materials to their own circumstances and customer needs.

Some commenters asserted that use of the illustrations may place entities subject to the Interagency NTM Guidance at a competitive disadvantage. In this regard, we note that the Interagency NTM Guidance, which includes the consumer disclosure recommendations, is already in effect for these entities, and also has been adopted for state-regulated mortgage brokers and companies by over 30 state agencies and the District of Columbia.⁴ The illustrations will be helpful to those institutions that prefer not to incur the costs and burdens of developing their own consumer information documents to implement the recommendations in the Interagency NTM Guidance. Additionally, as previously noted, CSBS, AARMR, and NACCA stated their belief that the illustrations also could be used by state-licensed entities subject to state-issued guidance that parallels the Interagency NTM Guidance.

The Agencies agree with the commenters who urged simplification of the Proposed Illustrations, particularly Proposed Illustration No. 2. The specific changes made in response to

³ 72 FR 10533 (March 8, 2007).

⁴ See www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/State_Implementation.htm.

these comments are detailed below. The Agencies opted not to include additional text in the illustrations that would discuss the benefits of nontraditional mortgage products, to ensure that the materials focus on an objective description of material terms, risks, and features of such products. Institutions are not precluded, of course, from providing factual information concerning the features of their products to consumers.

One commenter asked whether the consumer information brochure entitled “Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?” could be used in place of the illustrations to provide information to consumers. The information contemplated by the Interagency NTM Guidance serve a different purpose than this brochure. This detailed, multi-page publication includes valuable in-depth information, but it does not represent the more concise and focused consumer information contemplated by, and recommended in, the Interagency NTM Guidance. Illustrations 1 and 2, by contrast, are designed to be concise and focused so they can be quickly referenced by consumers during the mortgage shopping process. While, as explained in detail above, institutions are not required to use the illustrations, and may elect to provide the information contemplated in the Interagency NTM Guidance in a modified or alternate format, delivering this more detailed publication to consumers would not serve this same purpose or provide the information as recommended in the guidance.

The Agencies’ changes to each Proposed Illustration are discussed below.

A. Proposed Illustration No. 1

Although most commenters stated that Illustration No. 1 would be useful in helping consumers understand the risks of nontraditional mortgage products, several suggested that the Agencies make the illustration more user-friendly by using simpler language and larger fonts. Most trade organization and financial institution commenters generally agreed that Illustration

No. 1 would be helpful. Consumer groups, on the other hand, expressed their desire that the illustrations strongly communicate the risks of nontraditional mortgage products and add language clarifying that making the minimum payments on a payment option mortgage could lead to a reduction in a borrower's equity. Several consumer groups recommended that the illustration not suggest that consumers should request information orally from a lender, because consumers should be encouraged to review written information rather than rely on oral representations.

To address the commenters' concerns, the Agencies have simplified Illustration No. 1, deleted text where possible to shorten the length of the illustration, and made formatting changes to improve readability. Additionally, the Agencies have included language clarifying that making the minimum payments on a payment option mortgage could lead to a reduction in a borrower's equity. The Agencies have also added language advising consumers that if they do not understand the terms of a particular loan, they should not sign any loan contracts, and may want to consider other types of loans.

B. Proposed Illustration No. 2

Many commenters found proposed Illustration No. 2 confusing. Specifically, several commenters said the footnotes and the explanation of the minimum monthly payment row for years one through five of a payment option ARM would confuse consumers. A few commenters suggested that Illustration No. 2 would be most helpful to consumers if a loan officer or credit counselor reviewed it with them. Additionally, one financial institution suggested that Illustration No. 2 should emphasize the risks of payment shock and negative amortization.

One industry trade group stated that assuming borrowers make minimum payments is unrealistic. This commenter added that the interest rates in the examples should represent a

typical interest rate environment in which a fixed rate loan would have a higher rate than an adjustable rate loan. However, one financial institution suggested that the illustration should use the same interest rates for all the products to make comparison easier. One trade group stated that the rates for interest-only and payment option ARM loans should be higher to reflect the terms offered to non-prime borrowers. Two commenters stated that the illustration should use a \$100,000 loan amount that would be easier for consumers to compare to their loan amounts than the \$180,000 amount used in the proposed illustration.

A few commenters warned against using any assumptions that could become dated. Instead, one industry group suggested that payment amounts and interest rate information in Illustration No. 2 should be left blank so that loan officers and consumers could fill out the numbers themselves as they discuss and consider loan options. Another commenter suggested that the Agencies create a Web site where consumers could input their own specific information into different mortgage structures and get accurate and easy-to-understand cost alternatives.

To address commenter concerns, and to maintain consistency with the Interagency NTM Guidance, the Agencies have simplified Illustration No. 2 by reducing the number of products for which information is provided. The simplified illustration eliminates the need for footnotes or similar explanations. Additionally, the Agencies made formatting changes to draw consumers' attention to the important points the chart seeks to illustrate.

The Agencies agreed with commenters that a sample loan amount of \$180,000 could make it more difficult for consumers to estimate their own payment amounts. The Agencies, therefore, have adopted a representative loan amount of \$200,000, which is closer to the national median price for a single family home than the \$100,000 loan amount suggested by some commenters.

C. Proposed Illustration No. 3

The Agencies received the fewest specific comments on Illustration No. 3. Moreover, commenters did not express concern that consumers would have difficulty understanding Illustration No. 3. Several commenters, however, asked the Agencies to make clear that lenders will have flexibility with regard to how and when to provide the information contemplated by the third illustration. One trade group stated that the third illustration could be burdensome for lenders that do not provide monthly statements. Similarly, another trade group asked the Agencies to state that lenders could provide the third illustration less frequently than monthly, or through an explanation on the lender's Web site. In contrast, another trade group stated that the Agencies should encourage lenders to provide monthly statements.

One financial institution recommended that the illustration include the resulting loan balance with each payment choice so that the consumer can see how their choice affects the loan on a monthly basis. However, one financial institution and one trade group commenter stated that providing specific payment information would be burdensome and that lenders would require implementation time to make system changes.

After reviewing and considering the comments, the Agencies decided not to make substantial changes to Illustration No. 3. The Interagency NTM Guidance recommends that *if* institutions provide monthly statements to consumers on payment option mortgages, those monthly statements should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. Illustration No. 3 shows one way in which this information could be presented. Financial institutions retain the flexibility to provide the information in a format best suited to their customer's needs. Moreover, it is important to note this illustration is not

intended to set forth all of the information lenders could provide that may be useful, such as the current loan balance, an itemization of the payment amount devoted to interest and to principal, and whether the loan balance has increased.

The final illustrations appear below.

Illustration 1

Important Facts About Interest-Only and Payment Option Mortgages

Whether you are buying a house or refinancing your mortgage, this information can help you decide if an interest-only mortgage or a payment option mortgage is right for you. These mortgages can be complicated. If you do not understand how they work, you should not sign any loan contracts, and you might want to consider other types of loans.

Interest-Only Mortgages allow you to pay only the interest on the money you borrowed for the first few years of the mortgage (the “interest-only period”).

If you pay only the amount due, then at the end of the interest-only period:

- You will still owe the original amount you borrowed.
- Your monthly payment will increase because you must pay back the principal as well as interest. Your payment could increase even more if you have an adjustable rate mortgage (“ARM”) and interest rates increase.

Payment Option Mortgages allow you to choose among several payment options each month during the first few years of the loan (the “option period”). The option period will end earlier than scheduled if the amount you owe grows beyond a set limit—for example, 110% or 125% of your original mortgage amount.

During the option period, the payment options usually include:

- A payment of principal and interest, which reduces the amount you owe over time.
- An interest-only payment, which does not reduce the amount you owe.
- A minimum payment, which may be less than the interest due that month. *If you choose this option, any unpaid interest will increase the amount you owe.*

At the end of the option period, depending on what payment options you chose:

- You could owe substantially more than the original amount you borrowed.
- Your monthly payment could increase significantly because:
 - You may have to start paying back principal, as well as interest.
 - Unpaid interest may have increased the amount you owe.
 - Interest rates may have increased (if you have an ARM).

Additional Information

► **Home Equity**—If you make interest-only payments, your payments are not building home equity. And, if you make only the minimum payment on a payment option mortgage, you may be losing home equity. This may make it harder to refinance your mortgage or to obtain funds from selling or refinancing your home.

► **Prepayment Penalties**—Some mortgages require you to pay a lump-sum prepayment penalty if you sell your home or refinance during the first few years of the loan. You should find out if your mortgage has a prepayment penalty, how it works, and how much it could be.

► **No Doc/Low Doc Loans**—“Reduced documentation” or “stated income” loans usually have higher interest rates or other costs compared to “full documentation” loans that require you to verify your income and assets.

Illustration 2

SAMPLE MORTGAGE COMPARISON

(Not actual loans available)

Sample Loan Amount \$200,000 – 30-Year Term – Interest Rates For Example Purposes Only

	Traditional Fixed Rate Mortgage (7%)	5-Year Interest-Only ARM (initial rate 7%; maximum rate 12%)	Payment Option ARM (rate in 1 st month 2%; variable rate after 1 st month (starting at 7%); maximum rate 12%)
REQUIRED MONTHLY PAYMENTS			
Years 1-5	\$1,331	\$1,167	\$739–\$987 (increasing annually)
Year 6 – if rates don't change	\$1,331	\$1,414	\$1,565
Year 6 – if rates rise 2%	\$1,331	\$1,678	\$1,859
Year 8 – if rates rise 5%	\$1,331	\$2,094	\$2,319
EFFECT ON LOAN BALANCE AND HOME EQUITY			
After 5 Years, How Much Will You Owe?	\$188,263	\$200,000	\$221,486
After 5 Years, How Much Home Equity Have Your Loan Payments Built?	\$11,737	\$0	NEGATIVE \$21,486

Illustration 3

Your Payment Options This Month	Amount	Impact
Principal and Interest Payment	\$ _____	<ul style="list-style-type: none">• You will pay some of the principal on your loan.• You will reduce your loan balance.
Interest-Only Payment	\$ _____	<ul style="list-style-type: none">• You will not pay any principal on your loan.• You will not reduce your loan balance.
Minimum Payment	\$ _____	<ul style="list-style-type: none">• You [will] [will not] cover the interest on your loan.• You [will not] [will] increase your loan balance.

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED
“ILLUSTRATIONS OF CONSUMER INFORMATION FOR NONTRADITIONAL
MORTGAGE PRODUCTS”]

Dated:

John C. Dugan,
Comptroller of the Currency

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED
“ILLUSTRATIONS OF CONSUMER INFORMATION FOR NONTRADITIONAL
MORTGAGE PRODUCTS”]

By order of the Board of Governors of the Federal Reserve System, [DATE]

Jennifer J. Johnson
Secretary of the Board

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED
“ILLUSTRATIONS OF CONSUMER INFORMATION FOR NONTRADITIONAL
MORTGAGE PRODUCTS”]

Dated at Washington, D.C., the ___ day of _____, 2007

By order of the Federal Deposit Insurance Corporation

Robert E. Feldman,
Executive Secretary

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED
“ILLUSTRATIONS OF CONSUMER INFORMATION FOR NONTRADITIONAL
MORTGAGE PRODUCTS”]

Dated: [_____]]
By the Office of Thrift Supervision

John Reich,
Director

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED
“ILLUSTRATIONS OF CONSUMER INFORMATION FOR NONTRADITIONAL
MORTGAGE PRODUCTS”]

Dated: [_____]]
By the National Credit Union Administration

JoAnn M. Johnson,
Chairman