BEFORE THE
BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM

In the Matter of
Request for Comments on Truth in Lending, Proposed Rule

Docket No. R-1305

Comments of the Staff of
the Bureau of Consumer Protection,
the Bureau of Economics,
and the Office of Policy Planning
of the Federal Trade Commission

April 8, 2008*

***These comments represent the views of the staff of the Bureau of Consumer Protection, the Bureau of Economics, and the Office of Policy Planning of the Federal Trade Commission. They do not necessarily represent the views of the Federal Trade Commission or any individual Commissioner. The Commission has, however, voted to authorize the staff to submit these comments.**

I. Introduction

On January 9, 2008, the Federal Reserve Board ("Board" or "FRB") published a Proposed Rule restricting certain mortgage practices under the Truth in Lending Act and the Home Ownership Equity Protection Act.[1] Staff of the Federal Trade Commission's Bureau of Consumer Protection, Bureau of Economics, and Office of Policy Planning ("FTC Staff") appreciates the opportunity to file this comment on the Proposed Rule.

As the primary federal agency that enforces consumer credit laws with respect to non-depository institutions, the Commission has wide-ranging responsibility regarding consumer financial issues in the mortgage market, including those involving mortgage lenders, brokers, and servicers. The FTC enforces a number of federal laws governing mortgage lending, including the Truth in Lending Act ("TILA")[2] and the Home Ownership and Equity Protection Act ("HOEPA").[3] The Commission also enforces Section 5 of the Federal Trade Commission Act ("FTC Act"), which more generally prohibits unfair or deceptive acts and practices in the marketplace.[4] In addition, the Commission conducts research on mortgage lending and related topics, develops consumer and business education materials,[5] responds to inquiries about these matters from consumers, industry and the media, and works with other federal and state law enforcement entities to protect consumers from unfair or deceptive mortgage lending and servicing practices.

The FTC staff recognizes that, in the past year, there has been a sharp increase in delinquencies and foreclosures in the mortgage lending market, especially the subprime mortgage market. In 2007, there were an estimated 2.2 million foreclosure filings in the United

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1 Truth In Lending, Proposed Rule, 73 Fed. Reg. 1672 (proposed Jan. 9, 2008), *available at* http://a257.g.akamaitech.net/7/257/2422/01jan20081800/edocket.access.gpo.gov/2008/pdf/E7-25058.pdf.

2 15 U.S.C. § 1601-1666j (requiring disclosures and establishing other requirements in connection with consumer credit transactions).

3 15 U.S.C. § 1639 (amending TILA to provide additional protections for consumers who enter into certain high-cost refinance mortgage loans).

4 15 U.S.C. § 45(a).

5 Materials on mortgage issues are available at the Commission's For Consumers Credit web page, at http://www.ftc.gov/bcp/menus/consumer/credit.shtm, under the category Mortgages/Real Estate. The web page includes consumer education materials such as "Mortgage Payments Sending You Reeling? Here's What to Do," "High-Rate, High-Fee Loans (HOEPA/Section 32 Mortgages)," and "Reverse Mortgages: Get the Facts Before Cashing In On Your Home's Equity."

States, a 75% increase from 2006.[6] Given the recent problems in the marketplace, the FTC staff generally supports efforts to improve the mortgage lending process for consumers.

The following comments on the Proposed Rule are based on the staff's consumer protection experience in the mortgage market and its research on consumer mortgage disclosures. First, the comment describes the unfair and deceptive practices challenged in the Commission's law enforcement actions and research on mortgage disclosure issues conducted by Commission staff. Second, it assesses the Board's proposals and concludes that the restrictions on appraisal, servicing, and advertising practices, and the revised timing requirement for disclosures, would be beneficial for consumers. The comment also notes that while the proposed restrictions for higher-cost loans appear to strike a reasonable balance, staff encourages the Board to continue to use its expertise to weigh the potential benefits and costs of the proposed restrictions and to consider any empirical evidence submitted in response to its Notice of Proposed Rulemaking to confirm that this balance is reasonable. Third, it assesses the Board's proposal regarding broker compensation disclosures and recommends an alternative approach.

II. Commission Law Enforcement Activity in Response to Unfair or Deceptive Practices in the Mortgage Lending Market

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 22 actions against companies and principals in the mortgage lending industry, involving companies large and small in various regions of the country.[7] Several of these cases have resulted in large monetary judgments, collectively returning more than $320

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[6] *See generally Foreclosure Aftermath: Preying on Senior Homeowners: Hearing Before Senate Special Committee on Aging,* 110th Cong. 1 (2008) (Prepared Statement of the Federal Trade Commission on Foreclosure Rescue Fraud), *available at* http://www.ftc.gov/os/testimony/P064814foreclosure.pdf.

[7] *FTC v. Safe Harbour Found. of Fl., Inc.*, No. 08-1185 (N.D. Ill. 2008); *FTC v. Mortgages Para Hispanos.Com Corp.,* No. 06-00019 (E.D. Tex. 2006); *FTC v. Ranney,* No. 04-1065 (D. Colo. 2004); *FTC v. Chase Fin. Funding, Inc,* No. 04-549 (C.D. Cal. 2004); *United States v. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. 2003); *FTC v. Diamond*, No. 02-5078 (N.D. Ill. 2002); *United States v. Mercantile Mortgage Co.*, No. 02-5079 (N.D. Ill. 2002); *FTC v. Associates First Capital Corp.,* No. 01-00606 (N.D. Ga. 2001); *FTC v. First Alliance Mortgage Co.,* No. 00-964 (C.D. Cal. 2000); *United States v. Action Loan Co.*, No. 00-511 (W.D. Ky. 2000); *FTC v. NuWest, Inc.*, No. 00-1197 (W.D. Wash. 2000); *United States v. Delta Funding Corp.*, No. 00-1872 (E.D.N.Y. 2000); *FTC v. Cooper Props.*, No. 99-07782 (C.D. Cal. 1999); *FTC v. Capitol Mortgage Corp.*, No. 99-580 (D. Utah 1999); *FTC v. CLS Fin. Serv., Inc.*, No. 99-1215 (W.D. Wash. 1999); *FTC v. Granite Mortgage, LLC,* No. 99-289 (E.D. Ky. 1999); *FTC v. Interstate Res. Corp.*, No. 99-5988 (S.D.N.Y. 1999); *FTC v. LAP Fin. Serv., Inc.*, No. 99-496 (W.D. Ky. 1999); *FTC v. Wasatch Credit Corp.*, No. 99-579 (D. Utah 1999); *In re FirstPlus Fin. Group, Inc.*, FTC Docket No. C-3984 (2000); *In re Fleet Fin., Inc.*, FTC Docket No. C-3899 (1999); *FTC v. Capital City Mortgage Corp.*, No. 98-00237 (D.D.C. 1998).

million to 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 lenders, brokers, and loan servicers. The insights from the Commission's law enforcement experience and research informs the FTC staff's view of the Proposed Rule.

In most of its mortgage lending cases, the Commission has challenged alleged deception in the advertising or marketing of subprime loans. For example, the FTC's complaint against a large subprime mortgage lender, Associates First Capital Corporation and Associates Corporation of North America ("The Associates"), alleged that the defendants marketed subprime mortgage loans through false and misleading statements about loan costs.[8] The Associates represented that consumers would save money when consolidating their existing debts, but these "savings" claims did not take into account the loan fees and closing costs the company typically added to the consumers' loan amounts. Further, the claims did not reveal that, for certain Associates loans, consumers would pay only interest and would still owe the entire principal amount in a "balloon" payment at the end of the loan term. The complaint also challenged as deceptive the Associates' practice of including single-premium credit insurance in loans, without disclosing its inclusion to consumers. The defendants paid a record-setting $215 million in consumer redress to settle the FTC complaint.[9]

In recent years, mortgage brokers have become an important part of the mortgage market, originating between 58-70% of mortgage loans.[10] The Commission has brought several enforcement actions against these entities for allegedly deceiving consumers about key loan terms, such as the existence of a prepayment penalty[11] or a large balloon payment due at the end

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8 *FTC v. Associates First Capital Corp.,* No. 01-00606 (N.D. Ga. 2001).

9 *FTC v. Associates First Capital Corp.,* No. 01-00606 (N.D. Ga. Sept. 19, 2002) (Order Preliminarily Approving Stipulated Final Judgment and Order). Defendants paid an additional $25 million to settle a concurrent class action.

10 Lew Sichelman, *Loan Brokers Lose Share, But Still Rule the Market,* REALTY TIMES, July 18, 2007, http://realtytimes.com/rtcpages/20070718_loseshare.htm; Press Release, Wholesale Access, New Research About Mortgage Brokers Published (July 28, 2005), *available at* http://www.wholesaleaccess.com/7_28_mbkr.shtml.

11 *FTC v. Chase Fin. Funding, Inc.*, No. 04-549 (C.D. Cal. 2004); *FTC v. Diamond*, No. 02-5078 (N.D. Ill. 2002). Prepayment penalties on subprime loans are deceptive when originators lead consumers to believe that their loans do not include prepayment penalties when in fact they do. For example, a borrower who holds a 2/28 subprime loan with a 3-year prepayment penalty, and whose creditor has misrepresented that the borrower could refinance without penalty before the loan is recast, has been subject to a deceptive practice in loan marketing.

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, in June 2004, the Commission sued Chase Financial Funding ("CFF"), a California mortgage broker, and its principals, in connection with sending unsolicited email and direct mail promising a "3.5% fixed payment loan."[14] The FTC alleged that CFF did not offer any such loan and that the loan CFF falsely advertised was actually a "payment option" adjustable rate mortgage in which interest accrued at a rate higher than advertised, the principal balance would increase if consumers made payments at the advertised rates, and payments were not "fixed."

In 2006, the Commission filed suit against a mortgage broker for allegedly deceiving Hispanic consumers who sought to refinance their homes by misrepresenting numerous key loan terms.[15] The alleged conduct was egregious because the lender conducted business with his clients almost entirely in Spanish but then provided at closing loan documents in English containing less favorable terms. In a settlement, the court entered a suspended judgment of $240,000 against the broker, and the broker paid $10,000 in consumer redress based on a documented inability to pay the full judgment amount. The court also entered a permanent injunction prohibiting the broker from misrepresenting loan terms.[16]

Recently, in September 2007, the Commission announced that it was warning mortgage brokers and lenders, and media outlets that carry their advertisements for home mortgages, that some advertising claims may violate federal law.[17] In warning letters, the agency advised over 200 advertisers and media outlets that certain mortgage ads may be deceptive in violation of Section 5 of the FTC Act or may violate the TILA. The ads, including some in Spanish, were identified in June 2007 during a nationwide review focused on claims for very low interest rates or monthly payment amounts without adequate disclosure of other important loan terms. The Commission will continue to monitor the claims made in mortgage advertising and take further action in appropriate cases.

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12 *FTC v. Diamond*, *supra* note 7.

13 *FTC v. Chase Fin. Funding*, *Inc.*, *supra* note 7; *FTC v. Ranney, supra* note 7*; FTC v. Diamond, supra* note 7.

14 *FTC v. Chase Fin. Funding, Inc.*, *supra* note 7.

15 *FTC v. Mortgages Para Hispanos.Com Corp.*, *supra* note 7.

16 *FTC v. Mortgages Para Hispanos.Com Corp.*, No. 06-00019 (E.D. Tex. Sept. 25, 2006) (Stipulated Final Judgment and Order of Permanent Injunction).

17 Press Release, FTC, FTC Warns Mortgage Advertisers and Media That Ads May Be Deceptive (Sept. 11, 2007), *available at* http://www.ftc.gov/opa/2007/09/mortsurf.shtm.

The Commission also has challenged allegedly deceptive and unfair practices in the servicing of mortgage loans.[18] For example, in November 2003, the Commission, along with the Department of Housing and Urban Development ("HUD"), announced a settlement with Fairbanks Capital Corp. and its parent company. The Commission alleged that Fairbanks (now called Select Portfolio Servicing, Inc.) failed to post consumers' payments upon receipt, charged unauthorized fees, used dishonest or abusive tactics to collect debts, and reported consumer payment information that it knew to be inaccurate to credit bureaus. To resolve these charges, Fairbanks and its former chief executive officer paid over $40 million in consumer redress, agreed to halt the alleged illegal practices, and implemented significant changes to company business practices.[19]

In addition to pursuing numerous law enforcement actions in the mortgage lending market, Commission staff also has conducted research on mortgage lending issues, including two recent studies of consumer mortgage disclosures.[20] The studies were conducted, in part, because the Commission's law enforcement experience has demonstrated that current mortgage disclosures are often ineffective in preventing deception. This research builds on FTC staff's substantial experience evaluating the role of consumer information and disclosures in a wide variety of markets.

One study, based on thirty-six in-depth interviews with recent mortgage customers and quantitative testing with over 800 mortgage customers, examined whether current federal mortgage disclosures effectively conveyed loan information to consumers and whether the

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[18] *United States v. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. 2003); *FTC v. Capital City Mortgage Corp.*, No. 98-00237 (D.D.C. 1998).

[19] *United States v. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. Nov. 21, 2003) (Order Preliminarily Approving Stipulated Final Judgment and Order as to Fairbanks Capital Corp. and Fairbanks Capital Holding Corp.); *United States v. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. Nov. 21, 2003) (Stipulated Final Judgment and Order as to Thomas D. Basmajian). After the Commission conducted a compliance review of the company in 2007, it filed a joint motion with defendants to modify the 2003 consent order. The order provides substantial benefits to consumers beyond those in the original order, including refunds of fees paid in certain circumstances. *United States v. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. Sept. 6, 2007) (Modified Stipulated Final Judgment and Order).

[20] FTC, BUREAU OF ECONOMICS STAFF REPORT, JAMES M. LACKO & JANIS K. PAPPALARDO, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS (2007), *available at* http://www.ftc.gov/os/2007/06/P025505mortgagedisclosurereport.pdf (Mortgage Disclosure Study); and FTC, BUREAU OF ECONOMICS STAFF REPORT, JAMES M. LACKO & JANIS K. PAPPALARDO, THE EFFECT OF MORTGAGE BROKER COMPENSATION DISCLOSURES ON CONSUMERS AND COMPETITION: A CONTROLLED EXPERIMENT (2004), *available at* http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf (Mortgage Broker Compensation Study).

disclosures could be improved. The study found that current mortgage disclosure forms fail to convey key mortgage costs and terms to many consumers, even for relatively simple, fixed-rate, fully-amortizing loans, and that it is possible to create significantly better disclosures that help consumers understand the costs and terms their mortgages.[21] The study found that, with current disclosures, both prime and subprime borrowers misunderstood key loan terms, and both groups benefitted significantly from a prototype version of improved disclosures developed for the study. Both groups had the most difficulty understanding the terms of more complex loans, for which the improved disclosures provided the greatest benefit.

An earlier study used a controlled experiment with more than 500 recent mortgage customers to examine the impact of mortgage broker compensation ("yield spread premium") disclosures proposed by HUD.[22] The study found that the disclosures confused consumers, leading many to choose loans that were more expensive than the available alternatives, and created a substantial consumer bias against broker loans, even when the broker loans cost the same or less than direct lender loans.

III. The Proposed Rule

The Board proposes to use its authority to amend the TILA's implementing regulations to achieve several important goals. The FTC staff supports the Board's goals of protecting consumers in the mortgage market from unfair, abusive, or deceptive lending and servicing practices while preserving responsible lending and sustainable home ownership; ensuring that advertisements for mortgage loans are accurate and not false or misleading; and providing consumers with transaction-specific disclosures early enough to use while shopping.

The Board's proposal seeks to add: four restrictions on underwriting criteria and loan terms for a newly-defined category of higher-priced mortgage loans; restrictions on appraisal practices; restrictions on servicing practices; restrictions on mortgage advertising; a revised timing requirement for mortgage loan disclosures in refinance loans; and a prohibition on lender payments to mortgage brokers unless the payments do not exceed the amount of total compensation that the broker has agreed to in advance with the consumer, less any amounts paid directly by the consumer.[23]

The Commission recognizes the need to proceed carefully in deciding whether any new restrictions are needed on mortgage lending. The expansion of the subprime credit market has benefitted many people by providing mortgages to purchase homes and opportunities to

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[21] *See* FTC Staff's Mortgage Disclosure Study, *supra* note 20.

[22] *See* FTC Staff's Mortgage Broker Compensation Study, *supra* note 20.

[23] Truth in Lending, Proposed Rule, 73 Fed. Reg. at 1673.

refinance.[24] Thus, in considering any new regulations, it is important to assess whether such proposed restrictions would impede unduly individuals' access to mortgage credit.

A. Protections for Higher-Priced Loans

The Board proposes to add new rules for higher-priced mortgages under Section 129(l)(2)(A) of HOEPA, which provides that it shall prohibit acts and practices in connection with: (a) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade HOEPA; and (b) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices or that are otherwise not in the interest of the borrower.[25] Consistent with HOEPA's legislative history,[26] the Board considered the current FTC Act standard for unfair and deceptive acts or practices, as well as standards applied under similar state statutes.[27]

The proposal seeks to establish a new category of "higher-priced mortgages" that would include virtually all subprime loans. For these loans, the proposal: prohibits a lender from engaging in a pattern or practice of lending without considering borrowers' ability to repay the loan,[28] prohibits a lender from making a loan by relying on income or assets that it does not verify,[29] restricts prepayment penalties on adjustable rate mortgages,[30] and requires that the lender establish an escrow account for the payment of property taxes and homeowners' insurance for at least one year.[31]

The Proposed Rule's restrictions target practices that have resulted in harm to many subprime mortgage borrowers. Of course, these limitations also may reduce the availability of

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[24] *See,* e.g., EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 1-6, 35 (2007). About 55 percent of subprime borrowers in 2006 obtained refinance loans. Press Release, Mortgage Bankers Association, Percentage of Subprime Loans Used by First-Time Home Buyers Up During the Second Half of 2006 (July 3, 2007), *available at* http://www.mortgagebankers.org/NewsandMedia/PressCenter/55453.htm.

[25] 15 U.S.C. § 1639(l).

[26] H.R. Rep. 103-652 (1994) (Conf. Rep.).

[27] Truth in Lending, Proposed Rule, 73 Fed. Reg. at 1679-80 (explaining federal and state unfairness standards).

[28] *Id.* at 1686-90.

[29] *Id.* at 1690-93.

[30] *Id.* at 1693-96.

[31] *Id.* at 1696-97.

credit or the choice of loan products for some subprime borrowers or impose costs or inconveniences upon others. While the FTC staff believes that these restrictions appear to strike a reasonable balance among these considerations, we encourage the Board to continue to use its expertise to weigh the potential benefits and costs of the proposed restrictions and to consider any empirical evidence submitted in response to its Notice of Proposed Rulemaking to confirm that this balance is reasonable.

The FTC staff agrees with the Board that any restrictions adopted should be limited to higher-priced loans. The practices appear to have been most prevalent and had the greatest impact on consumers in the subprime market.[32] When these practices cause financial difficulties for consumers, subprime borrowers typically have fewer resources to fall back on than do prime borrowers, especially in the case of ARMs, prepayment penalties, and loans underwritten based on initially-low teaser payments.[33] We therefore believe that it is reasonable for the Board to focus on the impact of these practices only in the context of higher-priced loans.

B. Appraisal Protections

The Proposed Rule would prohibit lenders or brokers from coercing an appraiser to inflate the value of a property.[34] The FTC staff agrees with the Board that pressuring an appraiser to misrepresent the value of a property distorts the lending process and harms consumers. The Commission staff believes that this is a reasonable regulation that will address a documented consumer harm[35] without imposing undue costs on consumers.

C. Servicing Protections

The Proposed Rule would amend TILA's implementing regulations to impose certain restrictions on mortgage loan servicers. Specifically, the proposal provides that no servicer

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32 *See*, *e.g.*, GRAMLICH, *supra* note 24, at 6-7, 17-18.

33 Statement on Subprime Mortgage Lending, 72 Fed. Reg. at 37,570; GRAMLICH, *supra* note 24, at 6-7, 17-18, 33-35.

34 Truth in Lending, Proposed Rule, 73 Fed. Reg. at 1700-01.

35 *See, e.g., Iowa ex rel. Miller v. Ameriquest Mortgage Co.,* No. 05771 EQCE-053090 (Iowa D. Ct. 2006) (Pls. Pet. 5) (cited by Truth in Lending, Proposed Rule, 73 Fed. Reg. at 1701) (alleging, among other things, that Ameriquest improperly influenced and accepted inflated appraisals); *Ending Mortgage Abuse: Safeguarding Homebuyers:* Hearing Before the Subcomm. on Housing, Transportation and Community Development of the S. Comm. on Banking, Housing and Urban Affairs, 110th Cong. 2, 4-7 (2007) (testimony of Alan E. Hummel on behalf of the Appraisal Institute, American Society of Appraisers, American Society of Farm Managers and Rural Appraisers, and National Association of Independent Fee Appraisers).

shall: (1) fail to credit a consumer's periodic payment as of the date received; (2) impose a late fee or delinquency charge if the only late fee or delinquency charge is due to a consumer's failure to include in a current payment a delinquency charge imposed on earlier payments; (3) fail to provide a current schedule of servicing fees and charges within a reasonable time of request; or (4) fail to provide an accurate payoff statement within a reasonable time of request.[36]

Consumers generally have little or no choice as to which company services their mortgage loans. To avoid a particular servicer, consumers may have to refinance or pay off their loans, which they may find impossible or unduly costly. It therefore is particularly important to protect consumers from the acts and practices of servicers that cause or could cause them harm. As discussed above, the FTC has brought a number of cases challenging the conduct of servicers as unfair or deceptive. The FTC staff believes that the proposed restrictions will protect consumers from these practices without imposing undue costs on servicers and, therefore, supports the proposed restrictions on loan servicing. Nevertheless, the FTC staff believes that it is critical that the Board clarify that the servicing acts and practices that it has determined to be unfair or deceptive for purposes of HOEPA do not limit the ability of the FTC to determine that other acts and practices are unfair or deceptive under the FTC Act.

Although supportive of the servicing protections, FTC staff has concerns that the proposed requirement to provide a current schedule of servicing fees and charges may not adequately protect consumers. Providing a schedule of servicing fees and charges provides consumers with some information, but it does not ensure that consumers get adequate notice of each fee imposed on their accounts. In law enforcement investigations, FTC staff has seen monthly statements that lump all fees together. In some cases, these fees are the largest single amount on the statement other than the "Principal Balance." Furthermore, servicer fee demands may include – but not differentiate between – interest-bearing corporate advances (amounts paid by the servicer on the consumer's behalf, such as property taxes) and other, non-interest bearing fees. Thus, the FTC staff believes that the Board should consider the costs and benefits of requiring servicers to itemize each new fee assessed during a month or other reasonable period of time.[37]

D. Mortgage Advertising Regulations

The Proposed Rule introduces a new set of regulations governing advertisements for both

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[36] Truth in Lending, Proposed Rule, 73 Fed. Reg. 1701-02.

[37] FTC staff also notes that, to the extent the FRB narrows the proposed rule to address partial payments, it should define "payment" as an amount that is equal to the scheduled monthly principal and interest amount or one that is short of that amount by a nominal amount. In the Commission's law enforcement work, it has seen companies that have had a policy to reject "partial" payments, when the only reason the payment was "partial" was because of default fees or charges for ancillary products.

open-end[38] and closed-end home-secured loans;[39] most importantly, it changes the advertising requirements for closed-end mortgages. The Proposed Rule strengthens the "clear and conspicuous" standard under TILA for disclosures in advertisements of open-end home equity plans and closed-end mortgages. It also regulates the disclosure of introductory or "teaser" rates or payments to require that they be accompanied by clear and conspicuous information about the rates or terms throughout the loan's duration. The Proposed Rule further prohibits seven specific advertising practices that it identifies as "deceptive or misleading:" (1) advertising as "fixed" a rate or payment that will change after a period of time unless the ad clearly and conspicuously discloses that such rate or payment is "fixed" for only a limited period of time; (2) comparing current rates or payments to the rates or payments under an advertised loan unless the ad discloses the rates or payments that will apply over the full term of the advertised loan; (3) falsely representing an advertised loan as being part of a government program or otherwise endorsed or sponsored by a government entity; (4) falsely representing an advertised loan as affiliated with the consumer's current lender; (5) making any claim that an advertised loan will eliminate debt or result in a waiver or forgiveness of a consumer's existing loan terms with, or obligations to, another creditor; (6) using the terms "counselor" or "financial advisor" in an advertisement to refer to a for-profit mortgage broker or mortgage lender; and (7) advertising mortgages in a language other than English while giving critical disclosures only in English.[40]

As discussed above, the FTC staff has a long history of bringing law enforcement actions to protect consumers from deceptive mortgage advertising. Based on its law enforcement experience, the Commission staff believes that consumers are often deceived by the seven advertising practices the Proposed Rule would prohibit. Moreover, prohibiting these practices is not likely to prohibit truthful, non-misleading speech that could help consumers make better-informed decisions concerning mortgage loans. Thus, the FTC staff supports the proposed restrictions on advertising practices. Nevertheless, the FTC staff believes that it is critical that the Board clarify that the mortgage advertising acts and practices that it has determined to be unfair or deceptive for purposes of HOEPA do not limit the ability of the FTC to determine that other acts and practices are unfair or deceptive under the FTC Act.

E. Revised Timing Requirement for Disclosures

Some of the current problems in mortgage markets may be attributable to consumers not receiving information they need to make well-informed decisions. Information policies that make mortgage characteristics and costs more transparent to consumers can help to prevent deception and make markets more efficient.

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38 Truth in Lending, Proposed Rule, 73 Fed. Reg. at 1705-08.

39 Id. at 1708-15.

40 Id. at 1704-15; proposed rule §§ 226.16, 226.24.

The Board's proposal seeks to ensure that the preliminary TILA disclosures are provided to refinancing consumers early enough to give them the necessary information to shop for mortgage loans and compare offers from various originators. The proposal would require that good faith estimates of the TILA disclosures be delivered or placed in the mail not later than three business days after the creditor receives the consumer's written application.[41] This proposal likely would help consumers shop for refinance mortgages, home equity loans, and reverse mortgages because they would receive more information about the loans when they had time to engage in further comparison shopping. Therefore, the FTC staff supports this proposal.

FTC staff also believes that, although consumers will benefit from improvement in the timing of the disclosures, they also would benefit substantially from improvement in the content and presentation of the disclosures. As noted above, the Commission recently announced the results of a study, conducted by staff of its Bureau of Economics, that confirmed the need to improve mortgage disclosures.[42] The study, based on in-depth interviews with several dozen recent mortgage customers and quantitative testing with over 800 mortgage customers, found that: (1) the current federally required disclosures fail to convey key mortgage costs to many consumers, even for relatively simple, fixed-rate, fully-amortizing loans; (2) better disclosures can significantly improve consumer recognition of mortgage costs; (3) both prime and subprime borrowers failed to understand key loan terms when viewing the current disclosures, and both benefitted from improved disclosures; and (4) improved disclosures provided the greatest benefit for more complex loans, for which both prime and subprime borrowers had the most difficulty understanding loan terms.

The results of the FTC staff study indicate that consumers in both the prime and subprime markets would benefit substantially from a comprehensive reform of mortgage disclosures that created a single, comprehensive disclosure of all key costs and terms of a loan, presented in language consumers can easily understand and in a form they can easily use, and provided early in the transaction to aid consumer shopping for the best loan. The study results also are consistent with the FTC staff's view that consumer testing often is critical in the development and evaluation of consumer disclosures. Thus, the Commission staff also recommends that the Board and HUD[43] consider undertaking a more comprehensive effort to

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41 *Id. at* 1713.

42 *See* FTC Staff's Mortgage Disclosure Study, *supra* note 20.

43 HUD recently published a Notice of Proposed Rulemaking with modifications to the mortgage disclosures required under the Real Estate Settlement Procedures Act ("RESPA") and Regulation X. Real Estate Settlement Procedures Act (RESPA): Proposed Rule to Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs, Proposed Rule, 73 Fed. Reg. 14030 (proposed Mar. 14, 2008), *available at* http://a257.g.akamaitech.net/7/257/2422/01jan20081800/edocket.access.gpo.gov/2008/pdf/08-1015.pdf.

improve federal mortgage disclosures, including evaluating whether a single mortgage disclosure document that consolidates information on the key costs and features of a mortgage would benefit consumers. The FTC staff would be pleased to work with the Board and HUD in such an effort to improve federal mortgage disclosures.

IV. Broker Compensation Proposal

The FTC staff supports the Board's goal of making mortgage shopping easier but urges the Board to re-consider the Proposed Rule's provisions on broker compensation disclosures. FTC staff research has shown that broker compensation disclosures are likely to harm consumers and competition. Alternative disclosures that clarify the role of mortgage originators, applied equally to all sectors of the market, would provide greater benefit to consumers and avoid adverse effects on consumers and competition.

A. Background

A mortgage broker often receives compensation from a lender in the form of a yield spread premium ("YSP"). A YSP is paid to a broker if the loan is originated at an interest rate higher than the minimum rate necessary to obtain the loan, and it reflects the higher value of the loan arising from the higher rate. Direct lenders that originate their own loans also earn premiums from loans originated at higher rates. Premiums earned by direct lenders may be passed on as compensation to the loan officers who made the loans or accrue as higher profits for the lenders.

A potential benefit of YSPs, if passed on to the borrower, is that they can be used to reduce up-front origination charges that otherwise would be paid by the borrower in cash at closing. The up-front costs are spread over the life of the loan through the higher monthly payments that arise from the higher interest rate. This option can be particularly beneficial for borrowers who do not have sufficient savings to cover the up-front charges in cash or who prefer to avoid a large up-front cash payment for other reasons. Borrowers who do not intend to hold the mortgage for a long time – because they foresee moving in the near future, for example – will be less impacted by future higher monthly payments and may wish to invest less cash up front. Some experts also have noted that, in refinancing transactions, using YSPs to reduce up-front costs can provide tax benefits to borrowers because the resulting higher interest payments are tax-deductible, while closing costs paid in cash at settlement are not.[44]

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[44] *See Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs,* 107th Cong. 5 (2002) (statement of Susan E. Woodward, Ph.D., Chairman of Sand Hill Econometrics, Inc.).

The extent to which YSPs are passed along to consumers to reduce closing costs differs across different brokers and consumers and depends, in part, on the level of competition in the market and how well consumers negotiate for the best deal. Proposals to disclose broker compensation are generally motivated by a concern that mortgage brokers are placing borrowers in loans with higher rates than necessary and using the YSPs to increase their compensation rather than reduce the up-front charges paid by the borrowers. When this occurs, borrowers pay higher interest rates without receiving a compensating benefit of lower up-front costs. Broker compensation disclosures are intended to help consumers more readily recognize the cost of a loan (particularly, high-cost loans), more effectively shop for low-cost loans, and better negotiate for lower loan costs.

B. Proposed Regulation of Broker Compensation Payments

The Proposed Rule would prohibit lenders from paying a YSP to a mortgage broker unless the payment does not exceed the amount of total compensation that the broker has agreed to in advance with the consumer. Lenders could demonstrate compliance by obtaining a copy of the broker-consumer agreement and ensuring that their payment to the broker does not exceed the amount stated in the agreement, reduced by any payments made directly by the consumer.[45]

The broker's agreement with the consumer also must state that the consumer will pay the entire compensation even if all or part is paid directly by the lender, and that a lender's payment to a broker can influence the broker to offer the consumer loan terms or products that are not in the consumer's interest or are not the most favorable the consumer could obtain. The broker must enter into this agreement before the consumer has paid any fee or submitted a written application, whichever is earlier. Model language for these disclosures will be provided in FRB staff commentary. The requirement applies to both prime and subprime loans but not to lender payments to their own loan officers or other employees in connection with loans made directly to consumers.[46]

C. Analysis and Recommendations

The FTC staff has conducted a study of broker compensation disclosures that were proposed by HUD in 2002.[47] In the study, FTC staff noted that the potential benefit of the

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45 Truth in Lending, Proposed Rule, 73 Fed. Reg. at 1698-1700; proposed rule § 226.36(a).

46 *Id. at* 1699-1700.

47 FTC Staff's Mortgage Broker Compensation Study, *supra* note 20. The FTC staff also submitted a comment on the HUD proposal. FTC Staff Comment Before the Department of Housing and Urban Development on Proposed Amendments to the Regulations Implementing the Real Estate Settlements Procedures Act (Oct. 28, 2002) (Docket No. FR-4727-P-01), *available at* http://www.ftc.gov/be/v030001.pdf.

proposed compensation disclosures was not readily apparent. Seller compensation is rarely disclosed in consumer markets. This is not surprising because consumers generally base their purchase decisions on the price they must pay. Consumers comparison-shop on prices to find the best deal, and retailers display and advertise their prices to attract consumers.

Consumers should shop in the same way when seeking the lowest cost mortgage that fits their needs and circumstances. Consumers should comparison shop on the costs they must pay for the loan – the interest rate, monthly payments (both current and future), and up-front costs – not how much the broker is earning on the transaction.[48]

Focusing consumers on the compensation that loan originators receive can confuse consumers about the price of loans.[49] This is particularly the case when some loan originators, but not others, are required to disclose their compensation. A broker and a direct lender may be offering the same loan, at the same interest rate, with the same closing costs, and earning the same compensation. However, under the Proposed Rule, only the broker would be required to disclose its compensation and warn consumers that the compensation may lead them to offer loan terms that are not in the consumer's interest or the most favorable the consumer could obtain. Such disclosures will make broker loans appear to be more expensive or less desirable than identical, or even more costly, direct lender loans. This may lead some consumers to select more expensive loans than they otherwise would have selected in the absence of the compensation disclosure.

Compensation disclosures also could have adverse effects on market efficiency and competition. A consumer focus on originator compensation rather than consumer costs might distort consumer choice away from the lowest cost providers, leading to less efficient, rather than more efficient outcomes. A consumer focus on compensation could reward less efficient, higher cost originators and lead to less efficiency in the market, which ultimately could result in higher prices for consumers. The asymmetric application of the proposed disclosures, which would apply only to mortgage brokers but not direct lenders, will aggravate any anticompetitive effects.

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[48] Consumers, particularly those who intend to hold the mortgage for the full term, also may find it useful to comparison shop on the annual percentage rate ("APR"). The APR states the total credit cost of the loan, including interest and other finance charges, as a yearly rate, taking into account the timing of the payments over the life of the loan.

[49] Indeed, an FTC staff study, described in more detail below, found that broker compensation disclosures led many consumers to choose loans that were more expensive than the available alternatives and created a substantial consumer bias against broker loans. *See infra* note 51 and accompanying text.

As noted above, in 2004 the FTC released a Bureau of Economics staff study that used a controlled experiment with over 500 recent mortgage customers to examine how well consumers could understand several variations of a broker compensation disclosure proposed by HUD.[50] The study found that the compensation disclosures confused consumers, leading many to choose loans that were more expensive than the available alternatives, and created a substantial consumer bias against broker loans, even when the broker loans cost the same or less than direct lender loans.[51] The FTC staff concluded, based on the results of its study, that broker compensation disclosures were likely to harm both consumers and competition in the mortgage market. Subsequent consumer tests of the disclosures conducted by HUD produced similar results.[52]

A key argument used to support broker compensation disclosures is that many consumers purportedly view mortgage brokers as trusted advisors who shop for the best loan for the consumer.[53] But broker compensation disclosures, particularly ones that create consumer confusion, are not the appropriate response to this problem. A better remedy would be to require a disclosure that clarified the role of brokers, alerting consumers to the fact that, just like direct lenders, brokers seek to maximize their own profits and may not provide the least expensive loan for which the consumer qualifies. This less restrictive remedy would address the problem without creating consumer confusion or harming competition. Moreover, consumers would benefit most if such a disclosure were required for all mortgage originators, lenders as well as brokers. Indeed, in the study the Board cites on this issue, 52 percent of older borrowers with lender-originated loans said that they had relied "a lot" on the lender to find the best mortgage for them, which is not strikingly different from the 70 percent with broker-originated loans who

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[50] *See* FTC Staff's Mortgage Broker Compensation Study, *supra* note 20.

[51] For example, in one part of the study, groups of participants were shown different cost disclosures for two identical loans. In the two groups that were shown cost information that did not include a broker compensation disclosure, 95 and 99 percent of the participants correctly recognized that both loans cost the same. However, in the three groups shown cost information that included a broker compensation disclosure for one of the loans, only 49-57 percent of the participants recognized that both loans cost the same. Moreover, 41-50 percent of the participants in the latter groups mistakenly believed that one of the two identical loans was less expensive than the other, with 75-90 percent of these believing that the direct lender loan (which did not disclose compensation) was less expensive than the broker loan (which did disclose compensation). The broker compensation disclosure induced an even stronger bias against the broker loan when participants were asked which loan they would choose if shopping for a mortgage. FTC Staff's Mortgage Broker Compensation Study, *supra* note 20, at ES5-7, 25-27, 29-31.

[52] HUD's tests are available at its webpage, Testing HUD's New Mortgage Disclosure Forms With American Homebuyers (last visited Mar. 14, 2008), *available at* http://www.huduser.org/publications/hsgfin/goodfaith.html.

[53] Truth in Lending, Proposed Rule, 73 Fed. Reg. at 1699.

said the same.[54] Similarly, in a Fannie Mae study, only 59% of respondents knew that housing lenders are not required by law to give them the best possible rates on loans.[55] These misperceptions could harm borrowers obtaining loan prices from either brokers or lenders.[56]

The FTC staff understands that the Board is conducting consumer research on the proposed disclosures and believes that the results of this research are likely to be useful in evaluating the effectiveness of the disclosures. Mortgage broker compensation disclosures should not be adopted unless reliable, quantitative consumer research demonstrates that the disclosures will provide benefits to consumers without imposing the adverse effects on consumers and competition found in earlier studies. The FTC staff also suggests that, as the Board evaluates alternatives, it consider, and possibly test, whether other disclosures, such as those suggested above, would be more beneficial for consumers.

V. Conclusion

The FTC staff supports initiatives to improve the mortgage lending process for consumers. These initiatives are particularly important in light of current problems that mortgage borrowers, especially subprime borrowers, are experiencing. The FTC staff hopes that this comment is useful to the FRB in its assessment of the impact of the Proposed Rule on consumers.

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[54] Kellie K. Kim Sum & Sharon Hermanson, *Experiences of Older Refinance Mortgages Loan Borrowers: Broker- and Lender-Originated Loans*, 83 DATA DIGEST 3 (Jan. 2003) (AARP Public Policy Inst.), *available at* http://assets.aarp.org/rgcenter/post-import/dd83_loans.pdf.

[55] FANNIE MAE, UNDERSTANDING AMERICA'S HOMEOWNERSHIP GAPS, 2003 FANNIE MAE NATIONAL HOUSING SURVEY 7 (2004), *available at* http://www.fanniemae.com/global/pdf/media/survey/survey2003.pdf.

[56] Indeed, the largest case of deceptive lending challenged by the Commission involved a direct lender. *See FTC v. Associates First Capital Corp.,* No. 01-00606 (N.D. Ga. 2001).

Respectfully submitted,

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