The Federal Reserve Board

Testimony of Governor Edward M. Gramlich

Reforms in the Truth in Lending Act and the Real Estate Settlement Procedures Act

Before the Subcommittee on Financial Institutions and Regulatory Relief and the Subcommittee on Housing Opportunity and Community Development of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate
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Despite a number of Congressional actions designed to give mortgage borrowers greater information and protection, today's mortgage lending process can still be characterized as confusing, costly, and far less than optimal. Hence the Federal Reserve Board and the Department of Housing and Urban Development (HUD) were eager to respond to Congress' request to make recommendations for improvement. At the outset, I should say we have enjoyed our cooperative working relationship with HUD.

We have spent two years considering possible reforms in the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA), two related but distinct statutes. We have concluded that meaningful TILA-RESPA reform can only be achieved through new legislation. Recommendations for such legislation are contained in the joint report (9.5 MB PDF) we are delivering to the Congress.

The report identifies four key policy questions. After giving some background, my testimony today covers those four questions.

The Truth in Lending Act
TILA is intended to promote the informed use of consumer credit, primarily through disclosure, though with some substantive restrictions. It requires creditors to highlight the cost of credit as a dollar amount (the finance charge) and as an annual percentage rate (the APR). TILA requires additional disclosures for a loan secured by a consumer's home, and permits consumers to rescind certain transactions that involve their principal dwelling. The Board's Regulation Z implements the act, and an official staff commentary interprets the regulation.

The disclosure rules that creditors must follow vary depending on the type of credit being offered. For example, there are separate rules for closed-end (installment) loans such as automobile or home mortgage loans, and for open-end (revolving) credit plans such as credit cards or home-equity lines of credit. Additional rules govern reverse mortgages and mortgages on which borrowers pay rates and fees above a certain amount.

The Real Estate Settlement Procedures Act

RESPA seeks to protect consumers from unnecessarily high real estate settlement costs, by providing them with information about the costs required to close a mortgage transaction and by prohibiting certain business practices. The two key RESPA cost disclosures are the good faith estimate of settlement costs and the settlement statement. The good faith estimate provides consumers with an itemized estimate of the costs they are expected to pay at closing. The settlement statement records the actual costs paid, such as fees for survey, appraisal, credit report, title examination and insurance, loan points, mortgage broker's fees, and amounts to be held in reserve accounts. RESPA also imposes other disclosure requirements in the mortgage servicing process, including initial and annual escrow account statements and notice of the transfer of loan servicing. RESPA is implemented by HUD's Regulation X.

RESPA prohibits kickbacks, referral fees, and unearned fees because these practices were found to unnecessarily increase the cost of settlement services to consumers. RESPA also limits the amounts creditors can collect for escrow accounts, prohibits sellers' requiring a purchaser/borrower to obtain title insurance from a particular title company, and provides rights for consumers when loan servicing is transferred.

The Agencies' Actions Regarding Reform

The Board and HUD have worked steadily since 1996 to respond to the Congressional mandate to reform and simplify TILA and RESPA disclosures. Initially the agencies considered whether Congressional goals could be achieved by changing administrative rules, but ultimately we decided that significant harmonizing of TILA and RESPA could only come about through legislation.

In April, 1997, the Board published a notice seeking comments on possible statutory changes. Generally, creditors supported reform to TILA and RESPA to improve clarity and certainty for compliance. Consumer advocates supported changes that would result in more user-friendly disclosures provided early enough to allow shopping among creditors, and that were more accurate to avoid unexpected charges at the loan closing.

The Board and HUD have also hosted public meetings. In July, 1997, the agencies jointly sponsored a forum to give interested parties an opportunity to present their views on the issues of simplifying and reforming TILA and RESPA. Some speakers discussed extensive reforms to the entire disclosure scheme for real-estate-secured lending, while others cautioned the Board and HUD against mere tinkering with the current law.

The forum followed hearings that the Board had held in June, 1997, in Los Angeles, Atlanta, and Washington, D.C. on home-equity lending and the so-called "high cost" loans covered by the Home Ownership and Equity Protection Act of 1994 (HOEPA). Although the focus of the hearings was HOEPA, there was also discussion of TILA's finance charge and the APR. The agencies also have met extensively with representatives of consumer groups and the industries involved in the mortgage lending process, including member organizations of the Mortgage Reform Working Group, a private sector group formed in 1997 to deliberate on possible reforms to TILA and RESPA.

The Board also commissioned consumer surveys and focus groups. The studies provided insight into information consumers use to shop for credit, and on consumers' understanding of the APR and other cost disclosures. And at several of its meetings in recent years, the Board's Consumer Advisory Council has considered efforts to reform and simplify TILA and RESPA.

Four Major Policy Questions Discussed in Report on TILA-RESPA Reform

The issues involved in mortgage loan reform are highly complex. To facilitate the Congress's study of the central issues of reform, our report focuses on four broad policy questions concerning closed-end home-secured loans: the effectiveness of the finance charge and the APR (a TILA question), the reliability of settlement cost disclosures (a RESPA question), the timing of disclosures (both), and substantive protections to target abusive lending practices (both).

1. Should the finance charge and APR disclosures be eliminated, or should they be modified and retained?

The Board and HUD recommend that the APR and finance charge concepts be retained, and that the definition of the finance charge (which affects the APR) be expanded to include all costs the consumer is required to pay in order to close the loan. The agencies also recommend that the interest rate on the note and a more informative explanation of the APR be added as disclosures so that consumers can better understand the distinction between the two rates.

Most of the attention given to TILA reform has focused on two issues: Should the APR be retained as a measure of the overall cost of credit, and should the definition of a finance charge be revised to include more (or fewer) costs. The same cost items are included in both concepts, but the finance charge is expressed as the full dollar cost of borrowing over all years, while the APR is that dollar cost expressed as an annualized percentage rate, comparable to an interest rate.

In principle, TILA defines the finance charge very broadly, as any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. Under this definition, the finance charge should include interest, points, and transaction fees.

But in practice the finance charge and the corresponding APR have never disclosed the full cost of credit. Because of legislated exceptions, TILA does not include a number of charges in the finance charge, most notably many closing costs associated with real-estate-secured loans, such as fees for appraisals and title insurance.

While some favor dropping the APR altogether, the Board believes in improving it. It is familiar to consumers, even though they may not fully understand it. It is simple and potentially comparable to the straight mortgage rate. It is easier for consumers to evaluate competing products with a single figure than by using a number of different costs such as interest, points, and closing costs. If more costs were included in the finance charge and reflected in the APR, the APR would become an even better measuring rod. Also, including the interest rate on the TILA disclosure with the APR could help consumers better understand the difference between the two (currently the interest rate is not disclosed). A chart showing the treatment of various items under TILA and our proposed standard is given in Attachment A.

The key to improving the usefulness of the APR is in revising the definition of the finance charge. TILA's current "some fees in, some fees out" approach produces a finance charge and APR that for consumers is incomplete as a measure of the cost of credit and for creditors is unnecessarily complicated. Indeed, the Congress recognized the need for possible changes and asked the Board to study the feasibility of a more inclusive finance charge.

The Board and HUD believe that the finance charge should be defined as *the costs the consumer is required to pay to get credit*. Under this approach, many fees now excluded from the finance charge would be included. But this test would still exclude costs that are paid in comparable cash transactions (such as property taxes) and costs for optional services (such as credit life insurance). We believe that such a required-to-pay definition would provide both consumers and creditors with the most consistent basis for comparison shopping.

2. Should creditors be required to provide firmer quotes for closing costs disclosed under RESPA?

The Board and HUD recommend that creditors be required to give consumers more reliable closing cost information to promote shopping and competition. Creditors should be given a choice between guaranteeing settlement costs and providing a good faith estimate that is accurate within a specified tolerance. HUD testimony discusses additional HUD recommendations.

RESPA requires creditors to list all costs they anticipate the consumer will have to pay to close a loan. A good faith estimate is provided at or soon after application, and a settlement statement containing the actual costs is provided at closing.

The Board and HUD believe that an essential element of mortgage reform is to create incentives for creditors to provide firmer cost disclosures to consumers. The agencies are concerned, for example, that some costs in the good faith estimate are significantly lower than those actually charged at closing, and that other costs are left off the good faith estimate altogether. To the extent that discrepancies exist, the good faith estimate is unreliable as a shopping tool. Requiring firmer figures for RESPA's early closing cost disclosures would also improve the finance charge and APR disclosures under TILA since many of the costs that go into those disclosures would be more accurate.

The Board and HUD have considered a number of ways for ensuring that closing costs are estimated more accurately. We agree that it would be appropriate to provide an incentive to creditors, such as giving an exemption for creditors and service providers to RESPA's Section 8, which prohibits certain fees and may be thought to prevent volume-based discounts. The agencies recommend a dual disclosure system in which creditors could choose between guaranteeing the closing costs, hence entitling the creditor to an exemption under Section 8, and providing estimated closing costs that are accurate within a prescribed tolerance. This system would provide an incentive to creditors and others to guarantee costs without forcing them to guarantee. We believe the dual approach also offers an opportunity for the market to test whether guaranteed cost arrangements offer economical and efficient means for consumers to obtain mortgage loans.

3. Should the timing rules for providing cost disclosures to consumers be changed--and should creditors be required to provide disclosures before imposing substantial fees?

The Board and HUD recommend that consumers be given cost disclosures for home-secured loans as early as possible in the shopping process. The Board recommends that disclosures be provided not later than three days after application. HUD recommends even earlier disclosure, along with a limitation on application fees.

The Board and HUD also recommend that three days prior to closing, creditors should be required to redisclose significant changes in the APR or other material disclosures and *provide an accurate copy of the settlement statement. For nonpurchase home-secured transactions in which the right of rescission currently applies, the Board recommends that consumers also receive a notice of a pre-closing right to a refund at that time, to replace the existing rescission period in most instances.*

Currently in home-secured transactions, consumers receive RESPA or TILA disclosures at several different times. Generic information, such as consumer education booklets, are provided at or before application. Certain loan-specific disclosures are given at or several days after application, others are given at or several days before the time of closing. (The chart in Attachment B identifies the timing requirements under the two statutes.)

Congress has asked the Board and HUD to simplify and improve the timing of the disclosures under the two laws. The disclosure process would be simplified for creditors if the timing requirements for providing disclosures could be made more consistent. It would be further improved if the disclosures were given when they could be of most help to consumers. Another consideration is the extent to which shopping may be impeded by the payment of fees before consumers receive cost disclosures about their mortgage loan.

The Board and HUD agree that consumers should be given cost disclosures as early as possible in the shopping process. The agencies differ somewhat in their approaches on this issue, but in either case consumers would get better information sooner than at present.

The Board recommends that the initial cost disclosures be provided no later than three days after application. HUD recommends even earlier disclosure. The Board and HUD believe that rapid advances in technology (such as automated underwriting) will permit creditors to disclose firm costs at earlier stages of the loan origination process, and the Board believes that the marketplace may lead creditors to the standard contemplated by HUD. However, the Board believes that while some creditors can provide closing costs at first contact with consumers, other cannot. Even fewer creditors can fully underwrite the loan to determine the interest rate and points within a few days. The Board believes its more flexible approach strikes the appropriate balance of encouraging greater certainty in cost figures at an early stage without mandating a standard that is currently impossible for many creditors.

The Board recognizes that the ability to comparison shop will be curtailed for many consumers if they must pay more than a nominal amount to obtain disclosures, regardless of when the disclosures are provided. But unlike HUD, the Board does not support a limitation on fees, which could constrict the supply of credit. The Board believes that creditors will keep fees reasonable as they realize savings from the increased use of technology and as competition in mortgage lending increases.

With regard to subsequent disclosures, the Board and HUD both recommend that three days prior to closing creditors be required to redisclose significant changes in the APR or other material disclosures and to provide an accurate copy of the settlement statement. Consumers would receive final cost disclosures three days prior to closing (rather than at closing, the current practice) which will allow them to study the disclosures in an unpressured environment. Redisclosure at closing would be required if there were material changes from the disclosures provided three days before closing.

TILA now provides that, in certain transactions secured by a consumer's principal home, the consumer has three business days after becoming obligated on the debt to rescind the transaction. This right of rescission was created to allow consumers time to reexamine their credit contracts and cost disclosures and to reconsider whether they want to place their home at risk by offering it as security for the credit.

For transactions subject to this right of rescission, the Board also recommends that the disclosures given three days prior to closing also include a notice of the right not to complete the transaction and receive a refund. As an incentive to provide accurate disclosures in these transactions, the Board recommends that creditors be allowed to fund the loan at closing (assuming the consumer chooses to complete the transaction), when such a notice has been provided and when there are no material changes in the disclosures. If the consumer chooses not to complete the loan transaction, the creditor would be required to refund all fees, as is currently the case. If at closing there are material changes, closing can still occur but consumers would still have the three-day right to rescind, which they would be free to waive.

4. Should additional substantive consumer protections be added to the statutes?

The Board and HUD recommend that substantive protections be adopted that will target abusive lending practices without unduly interfering with the flow of credit or narrowing consumers' options in legitimate transactions. The agencies recommend restrictions against balloon payments and the advance collection of lump-sum premiums for credit insurance for loans covered by HOEPA. The Board and HUD also recommend requiring certain minimum standards for notice procedures creditors must follow in all home foreclosures. HUD testimony discusses additional HUD recommendations.

TILA was amended by HOEPA to address abusive practices. HOEPA applies to home-secured loans with rates or fees above a specified amount. The rate test for a HOEPA-covered loan is met if the APR at the time of closing exceeds by more than 10 percentage points the yield on Treasury securities of comparable maturity. The dollar test is met if the total points and fees exceed 8 percent of the loan amount or a certain dollar figure, whichever is greater. (The dollar figure is adjusted annually; for 1998 it is $435.) Home-purchase loans, reverse mortgages, and open-end lines of credit are exempt.

While HOEPA was an important step in curtailing abusive practices, unfortunately they persist. The report discusses various ways to deal with abusive lending practices. For example, the report discusses the problem of loan "flipping," where loans are refinanced repeatedly and consumers' equity is stripped by excessive fees added to the loan amount. These loans are made to appear attractive by monthly payments that are kept low, but they are often accompanied by a large balloon payment that the consumer must then refinance.

The report discusses possible ways to control flipping, including additional limitations on balloon payments and the ability to finance closing costs for loans subject to HOEPA. The report also discusses a number of approaches to avoid unwarranted foreclosures on consumers' homes, including counseling and uniform notice requirements that inform consumers about the foreclosure process and what steps must be taken--and by when--to forestall foreclosure. While it is difficult to control abusive lending practices, the Board and HUD believe that protections against these practices should be a part of any legislation enacted to simplify and reform TILA and RESPA. The Board and HUD further believe that any new rules should be part of a multi-faceted approach that also includes counseling, education, and voluntary industry action.

The Board believes that certain protections, narrowly drawn, clearly address some abusive practices. These fit the criteria of being narrowly tailored rules that will not unduly restrict credit and limit choice.

The Board and HUD join in two recommendations to protect consumers who obtain HOEPA-covered loans; one addresses balloon payments, the other addresses single-premium credit insurance.

Currently, balloon payments are prohibited for HOEPA-covered loans with maturities of less than five years. This prohibition is an important first step to curb the flipping that occurred before HOEPA was enacted. While most creditors believe low monthly payments and a balloon payment can be a useful tool in some cases and should be permitted, the current less-than-five-year rule can still be criticized because it allows creditors to flip mortgages with balloon loans that mature in five years. For HOEPA loans, consumers may be just as unlikely to repay or refinance the loan at better rates after five years than they are after two or three years. Hence the Board believes that HOEPA balloon notes should be further restricted either by lengthening the prohibition period, applying stronger prohibitions to a subset of OEPA loans, or prohibiting HOEPA balloon notes altogether.

The Board and HUD also recommend limiting creditors' ability to collect up-front certain credit insurance premiums on HOEPA-covered loans. Currently, TILA has some limitations regarding the sale of credit insurance (for life, disability, and unemployment). It permits creditors to exclude the cost of premiums for optional insurance from the disclosed finance charge and APR if it is truly optional and if the premium amount is disclosed.

Consumer advocates express concern about high-pressure sales tactics used on consumers to purchase high-priced credit insurance. The insurance is sometimes sold with a single premium collected up-front. If for some reason the mortgage loan is closed prematurely, it is often difficult for consumers to get back the unused portion of their premium.

Regulation of insurance, including the allowable premium rates, has historically been a matter for state law. The Board and HUD believe, however, that some abusive practices could be eliminated by prohibiting the advance collection of premiums on HOEPA-covered loans, so that consumers would pay for insurance periodically--and only for the time the loan is actually outstanding. This means that termination of the loan automatically would cancel both the coverage and any liability for future payments.

The final recommendation addressing abusive lending practices concerns notices that should be provided to consumers in general (HOEPA and non-HOEPA) prior to foreclosure. The Board and HUD believe that consumers who have been victims of abusive practices must be provided adequate opportunity to assert their rights in order to avoid unwarranted foreclosures.

For the most part, the procedures that a creditor must follow for foreclosure are governed by state law, local practice, and the terms of the relevant contract documents. These procedures include the amount or type of notice that consumers are entitled to regarding impending foreclosure. Some states require creditors to provide actual notices to consumers, but in other states notice by publication is deemed sufficient. In some states a judicial process is followed; the creditor must file a lawsuit and obtain a judgment in order to obtain permission to sell the property. Other states allow the use of a nonjudicial process, where the creditor merely notifies the borrower that the home will be advertised and sold, thereby placing the burden on the homeowner to take legal action to prevent the sale. In some cases consumers do not receive adequate information about the foreclosure and options that are available to them.

Requiring a minimum standard for the type of notice creditors must provide to consumers prior to foreclosure raises issues concerning preemption of state law. However, to avoid unannounced foreclosures on consumers' homes, the Board and HUD recommend that prior to any foreclosure sale, creditors must first provide a written explanation of any rights the consumer may have to cure the delinquency or redeem the property. Consumers should also be notified of steps they must take to exercise their rights, the process that will be followed in any foreclosure, and information about the availability of third-party credit counseling.

This concludes my discussion of the four key questions in reforming TILA-RESPA. We look forward to working further with HUD and the Congress to make the recommended changes. Thank you for the opportunity to testify.

Attachment A

Characterization of Costs as Finance Charges under Required-cost Test[1]

	Current TILA	Required-cost test
Loan origination fee	Y	Y
Loan discount	Y	Y
Per diem interest	Y	Y
Mortgage broker fee paid by borrower	Y	Y
Application fee	˜	Y
Annual fee for open-end plan	N	Y
Real estate commission	N	N
Credit report	N	Y
Appraisal/survey	N	Y
Lender's inspection fee (pre-consummation)	N	Y
Pest inspection	N	Y
Tax/flood certification	N	Y
Tax/flood service (life of loan)	Y	Y
Assumption fee (pre-consummation)	Y	Y
Document preparation (loan-related)	N	Y
Document preparation (deed)	N	N
VA application fee	Y	Y

Mortgage insurance premium	Y	Y
Hazard insurance premium	N	N (special exception)
Credit life/disability insurance (optional)	N	N
Credit life/disability insurance (required)	Y	Y
Reserves to be Deposited with Lender		
City/county property taxes	N	N
Title Charges		
Settlement or closing fee	˜	Y
Abstract or title search/title examination	N	Y
Title insurance/binder - lender's coverage	N	Y
Title insurance - owner's coverage	N	N
Notary fees (for mortgage)	N	Y
Attorney's fees (consumer)	N	N
Attorney's fees (lender)	˜	Y
Government Recording and Transfer Charges		
Recording fees: mortgage, release	N	Y
State/city/county tax/stamps: mortgage	N	Y
Recording fees: deed	N	N
State/city/county tax/stamps: deed	N	N
Transfer tax	N	N
Miscellaneous Fees		
Amortization schedule (optional)	N	N
Courier fees - settlement agent	˜	˜
Lock-in fee	Y	Y
Late payment charges	N	N
Escrow for required repairs	N	N

Footnote

1 All approaches exclude from the finance charge costs payable in a comparable cash transaction. The legend for the table is:

Y = treated as a finance charge under this approach
N = excluded from the finance charge under this approach
˜ = treatment depends on circumstances

Attachment B

Timetable for Providing Disclosures Under TILA and RESPA

Timing	TILA	RESPA
At or before referral		Affiliated business arrangement disclosure
At or before application	Home-secured lines of credit (HELOC) booklet & disclosure Adjustable rate mortgage (ARM) booklet & disclosure	
Within three days of application	TILA disclosure (home-purchase loans only)	HUD Special information booklet (home-purchase loans only) Good faith estimate (GFE) Initial transfer of servicing disclosure
Three days before closing/ consummation	HOEPA loan disclosure Reverse mortgage loan disclosure	
One day before closing/ consummation		HUD-1 settlement statement (if requested)
At closing/consummation	TILA disclosure (for all transactions except home-purchase; for home-purchase if change in terms) <Rescission notice	HUD-1 settlement statement Initial escrow account statement (within 45 days of closing)

Post closing/consummation	ARM notice of rate & payment changes	Annual escrow statement Transfer of servicing notice

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