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Statement by

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before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

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Mr. Chairman, I am glad to appear before your Committee today to offer the Board's comments on S.924, the Home Ownership and Equity Protection Act of 1993. The bill would amend the Truth in Lending Act (TILA) to require additional disclosures to consumers who take out "high cost mortgages" on their homes and to restrict the terms of such mortgages.

The bill is a commendable effort to address the complex issue generically called "reverse redlining" that has received considerable public attention over the past two years. It is clear that the sponsors have attempted to narrowly target the bill to areas of abuse, without overburdening the general market. If the bill progresses further, I think it is extremely important to maintain this focus. As my comments will make clear, it is the Board's view that failure to maintain a tight focus in the drafting of this bill entails substantial risk to many legitimate forms of consumer credit.

We can all agree that the abuses this bill seeks to remedy involve some truly heart wrenching personal tragedies. Some homeowners -- often elderly, with substantial equity in their homes but with little income -- have been targeted by home improvement contractors, loan brokers, finance companies, and mortgage companies for aggressive promotion of credit. Sometimes the potential borrowers seek the credit to consolidate other loans that are about to mature. They also obtain this type of credit for home repairs or other emergencies.

When the "dust settles," these borrowers may find that they have paid a high number of loan origination and broker points (often financed in the borrowed amount) and have agreed to a loan with an interest rate at the highest levels in the market -- sometimes with monthly payments that even exceed their monthly income and often with a balloon payment due. In some cases, it is maintained that borrowers have been defrauded because the terms of their credit have been misrepresented to them. Apparently, in a substantial number of cases, borrowers are unable to keep up the payments and end up losing their homes through foreclosure.

My colleagues and I, as well as officers and staff throughout the Federal Reserve System, have been closely following these issues and have, like the members of this Committee, been actively considering how such abuses might be prevented in the future. Board members have met with delegations of aggrieved homeowners, and have been distressed to hear first hand of their plight. We talked with those who currently cannot afford to repay their loans and who risk losing their homes through foreclosure. Given the particular concern about these practices in Boston, the Federal Reserve Bank of Boston has investigated these practices there, meeting with public officials and community groups to work on a practical response, working with affected borrowers, and conducting workshops on deceptive credit practices. It also reviewed the activities of one large nonbank subsidiary of a bank holding company in considerable detail.

Through all of these efforts we have come to appreciate the severity of the problems that high cost mortgages cause some borrowers. However, it has also become clear that finding a solution -- that itself does not have adverse consequences -- is a very difficult undertaking. The problem is multifaceted and complicated.

GENERAL COMMENTS ON THE LEGISLATIVE PROPOSAL

The bill would define a high cost mortgage as one that meets at least one of the following characteristics: (1) the annual percentage rate (APR) exceeds the yield on U.S. Treasury securities having maturities comparable to the transaction by more than 10 percentage points; (2) the consumer's percentage of total monthly debt to income exceeds 60 percent after the transaction is consummated; or (3) all points and other fees paid prior to closing exceed 8 percent of the loan amount. We strongly support the bill's exclusion from its coverage home purchase loans and open-end home equity lines of credit.

The proposed disclosures for high cost mortgages would be required three days before loan consummation. The special disclosures for these mortgages would be made earlier than the disclosures which are already required under the TILA (required before consummation) and would provide the borrower three days before closing to review these special disclosures and to decide whether to close the loan.

Under the bill, consumers would receive information about the effect of the security interest in the home, the APR, a statement of the consumer's remaining monthly income after making the payments on the transaction, information about variable rate features, and a statement that submitting a loan application and receiving disclosures does not obligate the consumer to complete the transaction. Some of this information (or some form of it) is already required by the TILA to be given before consummation of the transaction. The bill would also amend the TILA to restrict the terms of high cost mortgage loans -- for example, by prohibiting prepayment penalties, balloon payments, and negative amortization in such loans. Enforcement of these requirements is accomplished through the federal regulatory agencies and the courts, which could issue a judgment against a creditor for actual damages, civil penalties of up to $1,000 per violation (up to $500,000 in a class action) and, under the bill, forfeiture of all interest and fees earned.

In general, we believe that these problems should be addressed in a way that benefits consumers without undue compliance burden on creditors. For instance, overly restricting credit contract terms could create the risk that the cost of credit could increase or that it could be shut off altogether to marginal borrowers, or to those borrowers who happen to need credit due to special circumstances. The bill might create a disincentive to lending to these borrowers because a technical violation of even one of the proposed disclosure requirements could subject a creditor to the serious monetary penalties mentioned above. The risk of substantial litigation is likely to deter many legitimate lenders from entering this market. This should make us all the more careful to avoid having unintended results affect legitimate borrowers.

Everyone wants to protect consumers -- particularly those whose age or income makes them vulnerable to abusive lending practices -- against losing their homes, perhaps their only substantial asset. Appealing as it is to assume that more disclosure will cause people to act prudently, the Board is not convinced that more TILA information -- even if provided separately from and earlier than all other disclosures -- will effectively deter consumers from entering into high cost mortgages or ensure that they better understand the possible consequences. For example, it is likely that people facing default on preexisting loans would agree to any (even high cost) terms after full disclosure to fend off losing their homes. Ordinarily, given the choice of addressing a consumer protection issue with disclosure requirements or credit restrictions, we would opt for informing consumers about their credit choices, such as through TILA disclosures. We believe the credit market works best when it is unencumbered and when consumers have the information they need to compare available credit terms.

With high cost mortgages, however, consumers are already required to receive a substantial amount of disclosures about the terms of the loan. They receive the APR, a disclosure of the security interest and the payment schedule on such loans, for example, although later than is proposed under the bill. The benefit of the special disclosures in advance of this information is less than obvious since most of these homeowners already have three days after closing to review their existing cost disclosures and to cancel the transaction under current law.[1]

Obviously despite these protections, there are problems today. Borrowers nevertheless enter into these high cost obligations. It appears that few if any rescind these high cost transactions after receiving cost disclosures -- even consumers who may have been misled about their credit terms or were subjected to high pressure sales tactics. Thus, despite the good intentions of the sponsors and our own usual preference for disclosure rules over other restrictions, we have doubts whether simply increasing the information given will have much positive impact.

Thus, it may be that the more realistic way to address these various problems is through some of the substantive restrictions proposed in section 2 of the bill. The principal substantive restriction under the TILA now affecting these loans -- the right of rescission -- could be enhanced somehow for high cost loans, for example by lengthening the rescission period, as an

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[1]Over twenty years ago, a federal "cooling off" period was established in the TILA to resolve the problems caused homeowners by high pressure home improvement contractors. Under the TILA, consumers have a right to rescind <u>most</u> credit (except home purchase loans) secured by the home -- not just credit sales -- including most refinancings.

alternative to adopting restrictions on credit terms. This may prove particularly efficacious in cases where the borrower is actively solicited by a broker or lender, rather that having initiated the credit shopping. We would be happy to work with Committee staff on such an alternative, although I am not confident that high cost mortgage borrowers who may desperately need credit would be any more likely to rescind their loans with greater disclosures about rescission or a longer "cooling off period" than they are now.

SPECIFIC COMMENTS ON THE LEGISLATIVE PROPOSAL

We have attached, for the Committee's information, detailed comments on the entire bill. However, I would like to make a few comments on the provisions. Our objective is to have the Congress avoid the unintended consequence of terminating legitimate credit options in the process of enacting this bill. We suggest that the definition of a high cost mortgage be changed to be a transaction in which two or more of the conditions are satisfied. Consider each point in turn:

First, consider the criterion that high cost loans bear interest rates at more than 10 points above the current rate on Treasury securities of equal duration. I can understand that 10 percentage points may seem to be a large spread. In the present rate environment, however, this criterion implies an interest rate threshold of 14 to 15 percent. Yet many individuals, and not just those with low and moderate incomes, currently finance moderate sized home repair items by using their credit cards.

The effective interest rate on these cards may well be in the 18 to 21 percent range. It does not seem appropriate to consider extensions of credit at 14 or 15 percent rates as high cost when individuals now often assume much higher rates to accomplish the same purpose. The interest rate alone should not be considered the basis for establishing a loan as "high cost" unless a substantially higher spread is adopted.

Second, consider the 60 percent of income criterion. I have regularly opposed the use of such factors since income is often a poor guide to the ability to repay a loan. Consider first what I call the "widow situation." Let us imagine a widow who is left with her home, a little income (say, earnings on her husband's life insurance), and some real estate that could be fixed up and sold to improve her financial situation. She is consuming the capital represented by the life insurance proceeds. She realizes that cannot continue and indeed that is the reason why she is seeking to liquidate some of her property. But it is easy to imagine that the financing costs on the repairs she must undertake will exceed 60 percent of her income on a short term basis. Would you put at risk her ability to borrow by defining her loan as "high cost" simply because of her temporary low income? Again, I think that using simply one of the three criterion listed as sufficient for that definition creates an overly broad scope for this bill.

A second class of individuals who would be unintended victims of this legislation would be people who are starting small businesses and using their homes as equity for fixed term second mortgages. Because the incomes of these individuals are temporarily depressed, use of income as the sole criterion for the high cost designation is particularly ill advised. Yet these types of mortgages may be the best source of credit available to these potential entrepreneurs.

I might add that preliminary research at the Federal Reserve suggests that many government sanctioned mortgages implicitly involve loans to families which require more than 60 percent of their income to be used for credit purposes. In 1987, for example, roughly 10 to 12 percent of all FHA-insured refinancings involved borrowers with debt to income ratios greater than 60 percent. To avoid limiting the availability of credit under government sponsored programs, you might consider exempting these mortgages from coverage under the legislation.

Finally, the third criterion, an 8 percent limit on points and fees, is unduly restrictive for small loans. For many reasons, including the paperwork costs imposed by law and regulation, there is a substantial fixed cost involved in processing the loan. Indeed, this is often cited as the reason why many banks do not make small loans at all. An 8 percent limit on points and fees would make these loans even scarcer. Consider a $2,000 loan for a new roof, for example. The 8 point test translates to a $160 threshold. By any of the cost standards I am aware of, this is uncomfortably low.

Again, I am sure we all agree that we want to avoid the unintended consequence of making loans more difficult to get. My colleagues and I have wrestled with the conflicting tradeoffs involved. One option is to raise the thresholds proposed for each of the three criteria cited above. We believe that a better option is to look for a pattern of abusive terms by requiring that two of the three criteria be met before designating the loan as "high cost." Absent such a change, it would be difficult for us to conclude that this legislation would not risk significant impairment of loan availability in many legitimate and non-abusive instances.

Of all of the provisions in section 2 of the bill, the substantive limitations on balloon payments, negative amortization, and prepayment penalties seem particularly focused on the problems associated with high cost mortgages. Without the bill's exclusion of home purchase loans, some common balloon mortgage products such as the so-called "7-23" loans, could have been affected by the restrictions. And, without the exclusion, the negative amortization restrictions might well freeze out many potential home buyers from the market if the rate environment of the late 1970's should return. Further, as mentioned in our attached technical comments, the definition of negative amortization may have the unintended consequence of restricting reverse annuity mortgages because the balance on these loans increases with the payouts to the elderly borrower over the loan term. Thus, I again stress it is very important to keep the focus of the bill narrow.

We also have some concern about the provision that would amend the TILA assignee liability and expose an assignee to all the claims and defenses the consumer could assert against the creditor from failure to comply with any TILA requirement. The Federal Trade Commission's rule on unfair and deceptive practices addresses this issue to some degree already. That rule has essentially eliminated holder in due course status for assignees of consumer credit sale contracts, but not of direct loans. Also, the provision would create a second, more expansive standard for assignee liability than is present in the TILA, which now specifies that assignees are liable only for TILA violations that are apparent on the face of the documents for the loan assigned. In addition, the penalties are much more severe (loss of all finance charges paid) than under existing law. This potential for increased liability could discourage the purchase, and ultimately the origination, of loans -- and therefore restrict the availability of credit to marginal borrowers without alternative sources of credit.

Finally, to the extent the Congress chooses not to defer regulatory policy to the states, the Board believes a clear and complete federal preemption should be considered to clarify coverage and reduce regulatory compliance burdens.

CONCLUSION

The Committee is to be commended for attempting to resolve a complicated and important problem caused by high cost mortgages. It is clear that the issues raised by high cost mortgages are complex, and the appropriate federal response to the problems they raise is equally complicated. Many of these issues, relating to fraud and misrepresentation or usury, are already regulated by the states. Other issues, such as disclosure about the cost of credit and the ability to rescind a loan entered into through high-pressure tactics, are already handled to a great degree in federal law. The other issues raised, such as the terms of the credit contract, would be addressed in S.924 by imposing restrictions on the parties' ability to contract for those terms. Although we do not favor federal restrictions on credit terms, we believe that these restrictions would better address the problems created by high cost mortgages than the additional disclosures that have been proposed.

In crafting the final form of this legislation, it is essential for the Committee to avoid the problem of unintended consequences. Given the reported difficulties that some sectors of the economy have in accessing credit, it would be an unfortunate outcome of well intentioned legislation if these sectors were cut out of the credit market entirely. I would recommend to this Committee that during the course of their deliberations they solicit information from creditors active in second mortgage lending to determine how the proposed legislation might affect the availability of credit. We need to be better informed of this market, but absent perfect information, it is essential to keep the focus of this legislation as narrow as possible in order to eliminate abusive practices while minimizing adverse consequences which the Congress clearly would not have intended.

Attachment (1)

ATTACHMENT

FEDERAL RESERVE BOARD STAFF COMMENTS ON S. 942
THE HOME OWNERSHIP AND EQUITY PROTECTION ACT OF 1993

The following are technical and substantive comments of the Federal Reserve Board staff on S. 942, a bill amending the Truth in Lending Act (TILA) to provide additional disclosures and substantive prohibitions for certain high cost home-secured loans.

Section 1. SHORT TITLE.

Section 2. CONSUMER PROTECTIONS FOR HIGH COST MORTGAGES.

(a) DEFINITION. A new paragraph defining a "high cost mortgage" loan would be added to section 103.

- We suggest adding the new definition as new section 103(x), not section 103(v), to minimize the need to make conforming changes in the current law. For example, several provisions of the TILA refer to the definition of a residential mortgage transaction under section 103(w). (See TILA, §§ 125(e) and 128(b)(2).) Existing definitions in section 103(x)-(z) would be redesignated section 103(y)-(aa).

- We concur that the scope of coverage of the legislation should be limited to consumers' *principal* dwellings and not second homes, vacation homes, and the like. The concern about "high cost mortgages" is associated with loans secured by consumers' primary residences. It also seems appropriate that residential mortgage transactions (home purchase loans) and transactions under open-end credit plans (home equity lines of credit) would be exempt.

  We suggest that certain other loans or loan programs be considered for exemption to avoid covering transactions not intended to be covered by the legislation, for example, reverse mortgage loans (discussed at p. 7) and government sponsored loan programs.

Excessive annual percentage rate (APR). A "high cost mortgage" would include a loan that at the time of origination has an APR that will exceed by more than 10 percentage points the yield on Treasury securities having comparable maturities, as determined by the Board.

- We suggest substituting the phrase "at consummation" for "at the time the loan is originated." Under Regulation Z, which implements the TILA, consummation is defined to mean the time that a consumer becomes contractually obligated on a credit transaction. 12 C.F.R. § 226.2(a)(11)

- We suggest deleting the sentence beginning "[i]n the case of a variable rate loan..." as unnecessary. Currently under Regulation Z, if a creditor sets an initial interest rate that is not determined by the index or formula used to make later rate adjustments, the APR must be a *composite* based on the initial rate for as long as it is charged and, for the remainder of the term, the rate that would have been applied using the index or formula at the time of consummation. 12 C.F.R. § 226.17(c)(1)-10 (Supp. I)

  If the sentence is retained, for clarity (and consistent TILA terminology) we suggest substituting the phrase "rate that would have been applied using the index or formula at the time of consummation" for the phrase "rate or rates that will apply during subsequent periods." Also, at the end of the sentence "rates" would be changed to "rate. In spite of the first sentence of the paragraph which refers to the APR at consummation, the phrase "rates that will apply during subsequent periods" in the second sentence could be misconstrued to mean that at no time during the term of a variable rate loan may the rate be adjusted to exceed by 10 percentage points the yield on the relevant Treasury security. Such a rule would effectively require creditors to monitor variable rate loans to ensure that a rate adjustment during the loan term would not become "excessive." As an alternative to monitoring variable rate loans (which seems extremely burdensome), a creditor would likely automatically comply with new section 129, particularly given the civil liability that attaches for noncompliance.

- We suggest revising paragraph to read as follows:

  The annual percentage rate at consummation, whether the interest rate is fixed or variable, will exceed by more than 10 percentage points the yield on Treasury securities having comparable maturities, as determined by the Board.

Excessive debt-to-income ratio. A "high cost mortgage" would include a loan entered into by a consumer whose debt-to-income ratio exceeds 60 percent, immediately after the loan is consummated.

- This provision does not *require* creditors to undertake a debt-to-income analysis. If the consumer provides information about income and other debts and the debt-to-income ratio exceeds 60 percent, the new law would be triggered. Since this analysis is not done oftentimes on high cost loans, the condition would not have much of an impact. Nonetheless, requiring all creditors to conduct such an analysis may have the unintended consequence of adversely affecting certain government programs or credit availability generally, for example, for marginal consumers.

- If the condition is retained, it might be more narrowly tailored to target loans to consumers with a lot of equity in their homes and high debt-to-income ratios. For example, a requirement to do a debt-to-income analysis to determine whether it is in excess of 60% could be limited to loans to consumers with a certain amount of equity in their homes. Further, to ensure that government programs (like HUD's FHA low documentation refinancings) are not inadvertently covered, they could be exempted.

- The legislation provides that the Board may establish a different debt-to-income ratio that is in the public interest and consistent with the purposes of the act. The phrase "is in the public interest" seems unnecessary.

Excessive points and fees. A "high cost mortgage" would include a loan with all points and all fees payable at or before closing that exceed 8 percent of the "total loan amount."

- We suggest clarifying the phrase "all points and fees" in any accompanying report. For example, is use of the phrase "all points and fees" intended to exclude other finance charges (other than interest) such as origination fees, required credit life insurance and required broker fees? Does it apply only to points and nonfinance charge fees such as appraisal fees, property surveys, title examinations and other closing costs, brokers fees, and voluntary credit life insurance premiums?

- We suggest explaining the term "total loan amount" in any accompanying report to clarify whether the percentage is applied to the loan amount exclusive of any charges or fees that are financed (which we presume to be the case). Such fees would generally be considered part of the total loan amount.

- This condition may be overly broad. With regard to small loans, all fees and points of 8 percent above the loan amount are not inherently excessive. For example, under the proposed formula, a $10,000 home-secured loan with closing costs exceeding $800 would be considered a "high cost mortgage." To avoid coverage of loans not intended, a de minimis rule might be appropriate.

- We suggest revising this paragraph to read as follows:

For loans above [$10,000], finance charges, fees and other charges payable at or before closing will exceed 8 percent of the total loan amount.

<u>(b) MATERIAL DISCLOSURES</u>. No comment.

<u>(c) DEFINITION OF CREDITOR CLARIFIED</u>. A new definition of creditor for purposes of section 129 only would be added to section 103(f).

- Under Regulation Z, a person may be a creditor if consumer credit is extended more than five times for dwelling-secured transactions. (12 C.F.R. § 226.2(a)(17)n.3.) It is our understanding that the purpose of the proposed amendment to section 103(f) is to define as creditors persons extending consumer credit two or more times for home-secured transactions defined as high cost mortgages under section 129. The amendment is not intended to generally expand the definition of creditor by making arrangers of credit "creditors." We also assume the term "originates" is intended to mean that the loan is initially payable to the person extending the credit.

- We suggest that the phrase "or who originates a high cost mortgage loan through a broker" be deleted as unnecessary or that it be clarified. If a person who originates two or more high cost mortgages a year is a creditor for purposes of section 129, that would be the case whether or not the loan is originated through a broker. If the provision is intended to mean that a person who originates one loan through a broker is a creditor for purposes of section 129 and if no broker is involved, then the test is the origination of two or more loans, we suggest clarification of that point.

- We suggest that any accompanying report clarify the purpose of this provision, for example, by providing an example of the type of situation this provision is intended to cover (i.e., door-to-door salespersons).

<u>(d) DISCLOSURES REQUIRED AND CERTAIN TERMS PROHIBITED</u>. A new section 129 relating to "high cost mortgages" would be added.

<u>Disclosures</u>. Section 129(a) contains the disclosures that would have to be provided.

- We suggest deleting the word "initial" in paragraph (a)(2) as unnecessary. There is only one APR for purposes of TILA disclosure.

- The disclosure in paragraph (a)(3) seems to implicitly require a creditor to collect income information once a loan is determined to be a high cost mortgage. We suggest this point be clarified in any accompanying report. It is our understanding that a creditor would not be in compliance by disclosing "inapplicable" or "unknown" under the consumer's monthly gross cash income.

We suggest that the word "cash" be deleted as unnecessary. If the term is intended to distinguish different types of income, we suggest that any accompanying report provide examples to clarify "cash" and "noncash" income.

We suggest substituting "total monthly loan payment" for "total initial monthly payment."

- The disclosures in paragraphs (4) and (5) generally duplicate disclosures required under the current Regulation Z disclosure scheme for variable rate or adjustable rate mortgage (ARM) loans, though in the legislation the information required is more transaction specific. Generic disclosures about variable rate products must be given to consumers *at the time of application*, including a "worse case" payment example and a historical table illustrating how payments and a loan balance would be affected by interest rate changes, based on a hypothetical $10,000 loan. The ARM disclosures also include an explanation of how a consumer may calculate his or her actual monthly payment for a loan amount other than $10,000.

- Paragraph (4) would require disclosure of the maximum interest rate and payment. It is virtually impossible to determine a precise maximum monthly loan payment prior to consummation on a specific transaction because it is not clear when the maximum rate may be reached during the loan term. Under the ARM rules, in calculating the maximum rate and payment, the creditor must assume that the interest rate increases as rapidly as possible under the loan, and the maximum payment must reflect the amortization of the loan during this period. We would assume the same hypothesize should apply to the disclosure in this paragraph.

- In paragraph (5), we believe that the intended disclosure is a statement about the initial interest rate (typically a discount rate), not the APR (which is required under Regulation Z to be a composite of the initial rate and the fully-indexed rate or one based on a formula). In addition, the legislation does not require that the initial interest rate be disclosed, just the period of time that the rate will be in effect. We assume disclosure of the initial rate was intended as well, otherwise the information required to be provided seems incomplete.

  Disclosure of the rate that will be in effect after the initial period is over, assuming that current interest rates prevail, is required.

We recommend that paragraph (5) be revised to read as follows:

In the case of a variable rate loan with an initial rate that is not based on the index or formula that would apply at consummation, a statement of the initial rate, the period of time the initial rate will be in effect, and the rate that would have been in effect at consummation.

Time of disclosures. Section 129(b) would require that applicable "high cost mortgage" loan disclosures be given no later than three business days prior to consummation.

- We interpret the last sentence of paragraph (b) to mean that creditors may not change the terms of the loan between the time disclosures are given under section 129 and consummation of the loan (*i.e.* changes during the loan term are not prohibited by this provision).

No prepayment penalty. Section 129(c) would prohibit "high cost mortgage" loans from including prepayment penalties. It also prohibits the imposition of points and other fees when certain high cost mortgage loans are refinanced.

- Paragraph (c)(2) prohibits the use of the Rule of 78s to compute the rebate of interest on high cost mortgages, presumably those where interest is precomputed. Under section 933 of the Housing and Community Development Act of 1992, beginning September 30, 1993, creditors must compute refunds on any precomputed consumer credit transaction of a term exceeding 61 months based on a method which is *at least as favorable* to the consumer as the actuarial method. For consistency, we suggest the following: *For purposes of this subsection, any method of computing rebates of interest less favorable to the consumer than the actuarial method using simple interest is a prepayment penalty.*

- Under paragraph (c)(3), points, discount fees and prepaid finance charges would be prohibited *on the portion of a high cost mortgage loan that is refinanced* by the same creditor or an affiliate. Presumably if additional funds are advanced as part of the refinancing, points and other fees could be imposed on the "new advance" portion.

  We suggest that any accompanying report clarify what charges "discount fees" are intended to cover.

  As a technical amendment, we suggest the proposed paragraph (c)(3) be added as a new paragraph (g), LIMITATIONS ON REFINANCING FEES, as it seems to have no relationship to prepayment penalties.

- We believe that the exception in paragraph (c)(4) for prepayment penalties is too narrow. We recommend deleting "if the consumer prepays the full principal of the loan within 90 days of origination." It is not uncommon for a creditor at any time during the loan term to charge interest that would have been earned to the end of the month or the next payment due date when a consumer pays a loan in full between payment due dates. Moreover, it is our understanding that concerns about interest penalties are of a more severe nature, for example where a penalty of several additional months of unearned interest are imposed when a loan is prepaid.

<u>No balloon payments</u>. Section 129(d) would require that the aggregate of periodic payments in a high cost mortgage loan fully amortize the principal balance.

- We suggest that the section be amended to read, "*A high cost mortgage may not include terms under which, at the time of consummation, the aggregate amount of the regular periodic payments would not fully amortize the outstanding principal balance.*" As amended, the language would ensure that consumers will not become obligated for a payment schedule that does not amortize the outstanding principal in even installments. At the same time, the text addresses changes in circumstances during the loan term (such as missed payments) that would result in a higher payment being due at the end of the loan term.

<u>No negative amortization</u>. Section 129(e) would prohibit high cost mortgage loans from including a term that results in an increase in the principal balance during the loan term.

- A hypertechnical reading of this provision causes some concern about its potential impact on reverse mortgages, also known as reverse annuity or home equity conversion mortgages, assuming such transactions might be defined as high cost mortgage loans under one of the three conditions. Typically, the reverse mortgage loan is made on the basis of the consumer's equity in his or her home. Monthly payments are disbursed to the consumer (so the debt increases) for a fixed period or until the occurrence of an event such as the consumer's death. Repayment of the loan (generally a single payment and accrued interest) may be required at the end of the disbursement period or, for example, upon the consumer's death. We suggest language in any accompanying report clarifying that this provision does not apply to such loans. Alternatively, we suggest that such loans be exempted from this provision (or from the legislation generally).

- Negative amortization involves a loan payment schedule in which the outstanding principal balance goes up, rather than down, because the payments do not cover the full amount of interest due. The unpaid interest is added to the principal. We suggest clarifying by either revising the text or by a discussion in the legislative history that this prohibition is not intended to cover increases to principal balances due to events other than a change in interest rates, such as default provisions. For example, if a consumer fails to purchase property insurance as required by the mortgage documents, creditors typically may purchase insurance to protect the collateral and add the premium to the principal balance.

- We suggest the following revision to this paragraph:

  A high cost mortgage may not include terms under which the outstanding principal balance will increase over the course of the loan, because the payments do not cover the full amount of interest due.

No prepaid payments. Section 129(f) would prohibit high cost mortgage loans from including a term that deducts payments from the loan proceeds in advance of the regular due date.

- We suggest clarifying in the legislative history examples of the abuses this subsection is attempting to curb. Also, if the abuse affects regular installment payments, perhaps the prohibition against balloon payments addresses the issue, and the text of section 129(f) could be deleted in its entirety.

(e) CONFORMING AMENDMENTS. No comment.

Section 3. CIVIL LIABILITY.

(a) DAMAGES. We concur that the proposed amendment regarding damages should be a new paragraph (4) to section 130(a) of the TILA.

(b) STATE ATTORNEY GENERAL ENFORCEMENT. No comment.

(c) ASSIGNEE LIABILITY. Section (c) would add to the TILA a new standard for an assignee's liability when a creditor fails to comply with new section 129.

- An assignee of a high cost mortgage loan would be liable for all the claims and defenses a consumer could assert against the creditor. Recovery would be limited to the total amount paid by the consumer in connection with the transaction. This provision would be a substantial departure from the liability provisions for assignees, which became part of the TILA as a part of TIL simplification and limited assignee liability to violations on the face of the TILA disclosure statement.

Section 4. EFFECTIVE DATE.

The Board would be required to publish final rules implementing this legislation within 180 days of enactment. The mandatory compliance date for creditors would be 60 days following publication of the Board's final rule.

- Although 60 days is a relatively short period following publication of a final rule for creditors to prepare themselves to comply fully with the substantive and disclosure provisions of this proposed legislation, providing two months' lead time will be helpful to creditors.

May 18, 1993