

COMMENTS
of the
National Consumer Law Center
on behalf of its low-income clients

and

Alliance for a Just Society, Consumer Action,
National Association of Consumer Advocates, and the
National Community Reinvestment Coalition

to

Consumer Financial Protection Bureau
Regarding the
Know Before You Owe Proposed Mortgage Disclosures

Submitted April 18, 2012

I. Introduction

The National Consumer Law Center¹ respectfully submits the following comments on behalf of its low income clients, with Alliance for a Just Society, Consumer Action,² the National Community Reinvestment Coalition,³ and the National Association of Consumer Advocates.⁴

¹ The **National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eighteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (7th ed. 2010), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (4th ed. 2009 and Supp.), and *Foreclosures* (3rd ed. 2010), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to address predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to federal agencies on the regulations issued under these laws. These comments were written by NCLC attorney Andrew Pizor.

² **Consumer Action** (www.consumer-action.org) is a national non-profit education and advocacy organization that has served consumers since 1971. Consumer Action serves consumers nationwide by advancing consumer rights in the fields of credit, banking, housing, privacy, insurance and utilities. Consumer Action offers many free services to consumers and communities, including an assistance/referral hotline. Consumer Action also develops free consumer education modules, training, and multi-lingual materials for its network of more than 8,000 community based organizations. Consumer Action's publications are offered in Chinese, English, Korean, Spanish and Vietnamese.

³ The **National Community Reinvestment Coalition (NCRC)** is an association of more than 600 community-based organizations that work to promote access to basic banking services including credit and savings. Our members, including community reinvestment organizations, community development corporations, local and state government

We wish to begin by complimenting the CFPB for the openness of the *Know Before You Owe* project. By making public input so easy and by accepting input in the early stages of developing the new forms required by the Dodd-Frank Act, the CFPB has taken government transparency to a new level. We believe this manner of openness will help the Bureau in all its future rulemakings.

As much as we compliment the Bureau on its process for developing the new disclosures, we must also express with equal strength our deep concern over the direction the proposal has taken. The proposed disclosure forms are seriously flawed and we fear that adopting them will ultimately hinder, rather than promote, the goals of informed borrowing and consumer protection.

The proposal almost completely abandons the Annual Percentage Rate disclosure. Rather than emphasizing the APR or proposing a substitute, the new forms emphasize the initial interest rate and monthly payment—information that can easily be manipulated by disreputable creditors and that does not accurately disclose the cost of credit. In doing so the CFPB is, essentially, concluding that Congress was wrong in 1968 and that the past 40+ years of experience with TILA have been wasted.

We are also concerned by some aspects of the Bureau's approach to consumer testing. Consumer testing is certainly a useful tool for developing disclosure forms, and we encourage the Bureau to continue use testing to inform the development of policies and regulations. But it is important to remember how differences between the test setting and reality may affect the reliability of the results. The testing is conducted in a low-pressure environment where consumers are encouraged to read documents and contemplate the meaning of the disclosures. A real mortgage closing is characterized by the exact opposite circumstances. Borrowers are rushed and discouraged from reading. Even when they receive documents in advance, they do not receive the same prompts and encouragement to analyze the information provided.

The Bureau's decision to include test participants who are experienced with real estate transactions and are well-educated may also be a confounding factor in analyzing the results. Disclosures are most necessary for the least sophisticated consumer. While they must work for all consumers, those with experience and education are more likely to successfully interpret flawed disclosures than would more vulnerable consumers. Before settling on a final design, we encourage the Bureau to retest the disclosures on a panel of potential borrowers who have no experience with mortgages and who have no more than a high school education. The disclosures should be effective for the least sophisticated consumer.

Our comments below further discuss our concerns and make other recommendations for improving the Bureau's proposed disclosures and rule changes.

agencies, faith-based institutions, community organizing and civil rights groups, and minority and women-owned business associations help create and sustain affordable housing, job development and vibrant communities for America's working families.

⁴ The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

II. The Proposed Forms Are Flawed

A. The APR Should Be More Prominent Than the Interest Rate

1. History and Purpose of the APR

When Congress enacted the Truth in Lending Act in 1968 it intended to address the problems caused by a lack of transparency in credit pricing.⁵ Congress was concerned that creditors sometimes camouflaged the true cost of credit with extraneous fees that should have been included in the interest rate.⁶ This camouflage rendered “meaningless and deceptive” any interest rate quoted.⁷ TILA’s APR requirement was adopted to counteract this problem. “Just as the consumer is told the price of milk per quart and the price of gasoline per gallon, so must the buyer of credit be told the ‘unit price.’”⁸ The APR is the unit price of credit. “Without easy knowledge of this unit price for credit, it is virtually impossible for the ordinary person to shop for the best credit buy.”⁹

The APR is “the most important single piece of consumer shopping information.”¹⁰ It addresses two serious problems facing consumer borrowers: 1) non-standardized methods of computing interest that result in an apples-to-oranges comparisons of rates; and 2) the fact that rates alone cannot reflect the full cost of credit, given the additional fees charged in connection with most loans.¹¹ The APR is a simplifying heuristic that allows borrowers to decide between options that are otherwise overwhelmingly complex.¹²

2. The APR is Widely Recognized

Since adoption nearly 45 years ago the APR has become a widely recognized tool for credit shoppers. Studies have shown that more than 90% of the population is “aware” of the APR and that over 70% report using the APR to shop for closed-end credit.¹³ According to one study 78% of homeowners who refinanced their homes reported comparison shopping based on the APR.¹⁴ Even though these figures greatly exceed the percentage of the population that can explain how to calculate the APR, they show that consumers are using the APR as it was intended.

3. Consumers Don’t Need Expert Knowledge of the APR to Use It Effectively

Critics of the TILA disclosure rules emphasize problems with the APR as a disclosure tool. Common complaints include:

⁵ Elizabeth Renuart and Diane E. Thompson, *The Truth, The Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 *Yale J. on Regulation* 181, 181-82 (Summer 2008).

⁶ 109 Cong. Rec. 2027, 2029 (1963) (statement of Sen. Douglas).

⁷ *Id.*

⁸ 90 Cong. Rec. S2042 (daily ed. Jan. 31, 1967) (statement of Sen. Proxmire).

⁹ *Id.*

¹⁰ Renuart, *supra*, at 184.

¹¹ *Id.* at 186, citing Kathleen E. Keest, *Whither Now? Truth in Lending in Transition—Again*, 49 *Consumer L. Q. Rep.* 360, 361 (1995).

¹² *Id.* at 190.

¹³ *Id.* at 217.

¹⁴ *Id.* at 217, citing 213 Jinkook Lee & Jean M. Hogarth, *Consumer Information Search for Home Mortgages: Who, What, How Much, and What Else?*, 9 *Fin. Svcs. Rev.* 277, 286 (2000).

- the APR is unreliable because there are so many exceptions;
- the APR is not helpful for adjustable-rate loans;
- the APR is inaccurate for consumers who plan to sell or refinance in a few years;¹⁵
- consumers do not understand the difference between the APR and the contract interest rate;¹⁶ and
- consumers do not understand what goes into the APR.

These criticisms are easily addressed:

Reliability: The reliability problem can be resolved by eliminating the exceptions to the finance-charge definition. The CFPB has already indicated that it is considering this step.¹⁷ We have previously recommended this change in our comments to the Federal Reserve Board and incorporate those comments by reference.

Adjustable-Rate Mortgages: While it is true that the APR cannot accurately predict what credit will cost in the future, this criticism applies equally to disclosure of the contract rate. Though the APR is less than perfect in this regard, its value as a standardized, unit price makes it superior to the initial contract rate as a disclosure tool. Rather than discarding the APR for ARMs, its weaknesses are better addressed by supplementing it with other disclosures, such as the proposed payment summary and other proposed ARM-specific disclosures.

Consumers May Sell or Refinance Before Maturity: This concern overlooks the central purpose of the APR, which is to serve as a comparison tool. The amount of time a borrower expects to keep a loan has no bearing on the borrower's ability to compare the APR on different loan offers. If the APR is mathematically inaccurate because the borrower anticipates refinancing in 5 years rather than keeping the loan until maturity, the APR on all loans the borrower looks at will suffer the same flaw and will be viewed through the same lens. That is the point of unit pricing. Furthermore, "concern about the effect of duration is largely irrelevant except for the most sophisticated shoppers."¹⁸ The APR need not be perfect. As long as it is standardized it will function as intended.¹⁹

Consumer Comprehension: It does not matter whether consumers understand what goes into the APR or why it is different from the interest rate. What matters is that they can use it to make informed financial decisions. "Most of the U.S. population can compare two stated APRs."²⁰ As long as consumers can do that, they can use the APR to shop for the cheapest loan.

¹⁵ See Renuart, *supra*, at 188 n.20 (describing this issue).

¹⁶ Macro Int'l, Inc., Design and Testing of Effective Truth in Lending Disclosures 9, 26 (2007), available at www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf.

¹⁷ See CFPB, Small Business Review Panel For TILA-RESPA Integration Rulemaking Outline of Proposals Under Consideration Alternatives Considered (Feb. 21, 2012).

¹⁸ Renuart, *supra*, at 188 n.20 (citation omitted).

¹⁹ *Id.*

²⁰ *Id.* at 209 (extrapolating from research on quantitative literacy).

This particular criticism appears to be one of the major factors behind recent efforts to downplay the APR as a disclosure, but this concern is misplaced. Everyday life is filled with examples of how consumers can successfully use numerical disclosures without understanding their derivation.

- Shoe sizes,
- Dress sizes,
- Blood pressure measurements,
- Gasoline octane,
- Stock market indices (the Dow Jones Industrial Average or S&P 500),
- Light bulb wattage

Consumers routinely make appropriate use of these numbers without the faintest idea of what they mean or how they are calculated. We can look at a label and know whether clothing is our size. We can choose the gas we want by looking at the numbers labeling the pumps. We know a 100 watt bulb is brighter than one with 60 watts. While hardly anyone knows what units blood pressure is measured in, anyone who has visited a doctor knows lower is generally better. ***And that's all consumers need to know about the APR—lower is better.***

The Bureau has justified its abandonment of the APR by reference to consumer testing showing consumers do not understand the APR. However we are concerned that prior testing and the Bureau's ongoing tests have been skewed by the preconceived notion that consumers must have a scientific comprehension of the APR. The Bureau and previous researchers have asked the wrong question. The question is not whether consumers know the difference between the interest rate and the APR or what the APR is. The question is whether consumers can use the APR to find the least expensive loan.

We have not been able to locate any studies that directly test clear, simple language explaining that the APR is, in essence, a price tag and that a lower APR means a cheaper loan.²¹ A thorough examination of whether consumers can use the APR would require testing many variations of potential statements. The Bureau should also test other ways of disclosing the APR, such as by giving it a new name (ex. the "loan score" or "loan rating") and disclosing it as something other than a percentage rate.²² Instead it appears that the CFPB has only conducted limited testing on the APR and has not tested enough variations.

The Bureau's proposed disclosure form requires consumers to evaluate multiple price dimensions in order to compare loans. While some test participants may have done so successfully in a controlled setting, research into behavioral economics and experience suggest this will not work in the real world. Before the Bureau issues a proposed rule, the Bureau should further experiment with potential unitary price disclosures. The sticker price need not be the APR but the proposed forms will be less successful if they do not have a similar heuristic.

²¹ We encourage the Bureau to test many, simple variations of this concept, such as: "The lower the APR, the better," "A low APR will save you money," "The APR is the price-tag for a loan," "The APR is like the price for a loan--the lower the better."

²² Exhibit A to these comments includes some suggestions.

4. The Interest Rate Disclosure Is Ambiguous, Easily Manipulated, and Omits Prepaid Finance Charges

The contract interest rate is one of the most prominent disclosures on the proposed forms. Displayed in a large font on the first page, borrowers cannot avoid noticing it. As a result, it will almost certainly have an impact on the borrower’s opinion of an offer. This is unfortunate because it is also one of the most easily manipulated and least understood numbers in a loan contract.

The contract interest rate is only part of the cost of credit. Origination fees and closing costs add thousands of dollars to the cost of borrowing money and must be factored into the selection of a loan. Yet, by emphasizing the interest rate instead of the APR, the Bureau is emphasizing only one piece of this important equation.

The contract rate disclosed on the proposed form can be easily manipulated with the use of step-rate loans or ARMs having low teaser rates. The widespread use of hybrid ARMs in the subprime market illustrates the lure of a low teaser rate. While teaser rates can make the APR look deceptively low too, the APR at least requires consideration of the fully-indexed rate and inclusion of prepaid finance charges. Replacing the APR with the interest rate will encourage the market to return to offering teaser rates and will encourage the trend of shifting the cost of credit from the interest rate to prepaid finance charges.

The interest rate disclosure is also ambiguous because interest can be calculated three different ways: simple interest, add-on interest, and discount interest.²³ Interest can also be calculated over different time periods. So a disclosed rate could be annual or monthly. This means the disclosed interest rate on one loan may not be comparable to other loans. TILA requires use of the APR specifically to provide an apples-to-apples comparison. While the majority of contracts currently reflect the annual rate, usually calculated with the simple interest method, a disclosure form that highlights the contract interest rate rather than the APR will reward deceptive lenders who use other methods. This risk will be even greater in the fringe market, such as for home-improvement loans. Mandating use of the actuarial rate would only be a partial solution because the interest rate does not take into account the cost of prepaid finance charges.

An example shows how the Bureau’s proposed “Loan Terms” disclosure, using the contract rate, does not do the job as well as the APR.

| Sample Loans | Loan A | Loan B | Loan C |
|-------------------------|---------------|---------------|---------------|
| Loan amount | \$99,900 | \$100,200 | \$100,000 |
| Fixed-rate | 5% | 4.69% | 4.4% |
| Monthly payment | 536.28 | \$519.07 | \$500.76 |
| Settlement costs | \$5,000 | \$9,999 | \$11,000 |

The proposed disclosures provide the four items of information shown in the table above. This means there are four variables involved in comparing these loans. Research on quantitative

²³ National Consumer Law Center, *The Cost of Credit: Regulation, Preemption, and Industry Abuses* § 4.3 (4th ed. 2009 and Supp.).

literacy suggests that a significant number of consumers using the proposed disclosures would not be able to identify the most economical loan from among these examples. The available research suggests some consumers would try to compare the loans by evaluating two, three or maybe all of the variables—and would likely end up paying more than consumers who focused on only one variable.²⁴ Other consumers would simplify the decision by ignoring some variables and by approximating what is too difficult to calculate.²⁵ Some borrowers would inevitably focus on the rate, others the monthly payment, and some would look at the total closing costs. However, the only reliable way to decide which of these loans is the most economical, without extensive calculations, is to know the APR for each loan.²⁶ The Bureau proposes to bury this information where few consumers will see it.²⁷

B. Require an APR or Interest Rate Comparison Graph

One more way of addressing consumer difficulty with understanding the APR is to disclose it in a way that provides a context for understanding whether the APR on any given loan is good or bad in relation to commonly understood markers. The FRB proposed such a tool in August 2009 when the Board proposed disclosing the APR on a graph that would compare the disclosed loan to higher rate and prime rate loans. We were disappointed to see that the Bureau has not included this graph on any of the proposed model forms. Apparently the Bureau did not even attempt to test the effectiveness of such a disclosure.

The graph was a significant improvement for all the reasons described in the FRB’s description of the proposal. It alerts consumers to where the pending loan offer fits in relation to other rates available in the market. For consumers who have not adequately shopped for credit, this may encourage the consumer to shop elsewhere or to ask the creditor for a better rate. It also accommodates different learning styles and is likely to help attract the consumer’s attention to the importance of the APR. Showing the APR in context will also reinforce the concept that a lower APR is better for the consumer.

The mortgage industry reportedly objected that the graph would be misleading because borrowers might not be qualified for the prime rates shown on the left end of the graph, because Freddie’s Primary Mortgage Market Survey (PMMS) did not include the same finance charges as the APR, and because they thought it would be technically difficult to produce the graph. None of these objections are valid reasons for omitting the graph.

²⁴ Susan E. Woodward, *Consumer Confusion in the Mortgage Market 2* (July 14, 2003) (unpublished manuscript), available at www.sandhillecon.com/pdf/consumer_confusion.pdf (last viewed Mar. 19, 2007) (observing “Borrowers attempting more difficult shopping strategies that involve a tradeoff of rates and points pay higher fees on average than borrowers who roll closing costs into the interest rate and thus can shop on the basis of rate alone.”)

²⁵ Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 *Cornell L.R.* 1073, 1122 (2009).

²⁶

| Loan A | Loan B | Loan C |
|------------|------------|------------|
| 5.457% APR | 5.622% APR | 5.418% APR |

Calculation of APR assumes all settlement costs are prepaid finance charges.

²⁷ The Bureau further diminishes the utility of the APR disclosure by putting it next to the Total Interest Percentage (TIP) disclosure, which will always be dramatically higher than the APR. As a result, the APR will look deceptively low by comparison. The decision to juxtapose the APR and the TIP is one that would delight most bank marketing departments.

- Consumers who are not eligible for a better rate—whether due to poor credit or aspects of the loan they have requested—will not know unless they ask. In this sense, the graph will serve the same educational function as the credit score disclosures mandated by the Fair Credit Reporting Act. In addition, creditors routinely advertise rates that are only available to highly qualified borrowers, so they already expose their customers to rates for which they may not be qualified.
- Even though the APR/PMMS comparison is not a perfect one, all loans will be subject to the same comparison, putting all creditors on a level playing field. But, even if the APR/PMMS objection was more serious, there are alternative solutions. For example, the Bureau could collect APR data on prime loans and use that instead of the PMMS.
- Concerns about technical difficulties could be resolved by allowing a long implementation period.²⁸

III. Rule Changes Proposed in Small Business Review Panel Outline

A. Make the Lender Solely Responsible for Providing the Disclosures

The Bureau has raised two possibilities for assigning responsibility for providing the disclosures. We urge the Bureau to make the lender solely responsible. Setting a bright-line rule for responsibility will simplify enforcement of the rule and will avoid confusion between the lender and other parties to a closing. This will not prevent the lender from delegating authority to agents as it sees fit. But it will encourage the lender to ensure that the task is done properly by ensuring that someone is clearly accountable for errors. Lenders can adequately protect themselves from settlement agent mistakes by negotiating indemnification agreements with agents and by adopting business procedures that provide sufficient supervision.

B. Require Use of the Model Forms Under RESPA and Set Strict Standards Under TILA

We support the Bureau’s proposal to require creditors to use standardized model forms. The Bureau is going to great lengths to develop forms that adequately disclose important information. The final versions will reflect the Bureau’s careful testing and development of the language used in the disclosures as well as their appearance. It would be a mistake to then allow creditors to cherry-pick the parts of the forms they wished to use, or to use an entirely different form. Creditors have an incentive to disclose loan terms in a manner that encourages consumers to overlook or misinterpret information that does not favor the lender. If creditors were not required to use the model forms, it is simple to imagine a disclosure format that could favor a creditor without violating TILA or RESPA. Creditors already benefit from tremendous knowledge asymmetry in the loan origination process. Allowing them to deviate from carefully developed model forms allows them to further stack the deck and needlessly risks litigation over whether the creditor’s form complies with the law.

Though 15 U.S.C. § 1604(b) prevents the Bureau from requiring use of the model forms under TILA, the Bureau should mandate strict standards that require creditors who do not use the

²⁸ Or the Bureau could invite the public to invent an effective solution on Challenge.gov.

model forms to make the most important disclosures in a manner that will be as clear and effective as the model forms. This is especially important for disclosures that testing shows are particularly sensitive to format or terminology. The standards should mandate the order, language, font size, and format of key disclosures. Mandating uniformity will produce many benefits. If the format is uniform it means that, as consumers gain experience with the new disclosures, they will become more skilled at finding the information that is useful to them. A uniform format will also make it easier for consumers to make a head-to-head comparison of different loans, which may increase beneficial competition on loan terms.

Mandating the format of disclosures will also save time and money for creditors. An approach that allowed creditors to determine the format and language of disclosures would simply be a full employment bill for in-house legal departments. Mandating the format of disclosures also reduces creditors' potential liability, as there are fewer opportunities for them to make mistakes. The small category of loans subject to TILA but within the scope of RESPA are likely to be made by small, fringe lenders who are less likely to attract the attention of regulators. It is these creditors who are most likely to prey upon desperate borrowers. For that reason, the Bureau should leave them as little leeway as possible when designing their disclosure forms.

C. Eliminate the Exceptions to the Finance Charge Definition

We strongly support the Bureau's proposal to eliminate exceptions to the finance charge definition, as proposed by the FRB in 2009. We provided a detailed response to the FRB's proposal at that time, which may be viewed on our website.²⁹ These changes will make the APR a more valuable and effective tool that should be prominently disclosed. It would be a shame if the Bureau improved the APR with one hand, and brushed it under the rug with the other.

D. Expand the Zero Tolerance Rule for Increased Closing Costs

We support the Bureau's proposal to expand the coverage of the zero-tolerance rule for increasing closing costs. This would help reduce the occurrence of bait-and-switch in loan origination. Lenders and the settlement industry can control costs through advance planning and contractual agreements. There is no excuse for the many last-minute increases that have plagued borrowers. Expanding the zero-tolerance policy would eliminate the incentive to underestimate costs in hopes of ensnaring potential borrowers.

E. Require Delivery of the Final Settlement Disclosure At Least Three Business Days in Advance

The proposal to require delivery of the settlement disclosure at least three business days in advance will be a significant improvement. This will allow borrowers to review the loan terms outside the stressful, high-pressure environment often experienced at the settlement table. This will also give consumers time to ask questions and demand corrections where necessary. The list of triggers requiring issuance of a revised disclosure is, however, inadequate. The list should also include:

- changes in the loan principal;
- increases in the total monthly payment (PITI);

²⁹ http://www.nclc.org/images/pdf/foreclosure_mortgage/predatory_mortgage_lending/r-1366-with-app-dec09.pdf.

- addition of any feature that could cause the interest rate to increase (for example if the rate could increase when the borrower changes jobs, closes accounts, pays late, or cancels automatic account deductions used to pay the loan);³⁰
- changes in any debts to be paid-off with the loan proceeds.

Any of these changes could have a significant impact on the desirability of a loan even if they do not affect the APR.

The Bureau should also define “business day” in a manner that excludes Saturday and Sunday, as well as federal holidays.

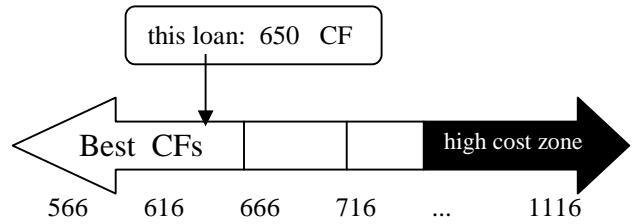
³⁰ At least one lender made mortgages that gave a discount on the interest rate for timely payment. The monthly payment and APR were disclosed based on the assumption that the borrower would earn the discount by paying in accordance with the terms of the note (i.e. that the borrower would pay on time). If the borrower paid late, once, the borrower would lose the incentive and the rate would increase. A lender could easily accomplish the same result with other incentives.

Exhibit A Suggestions for Alternative APR Disclosures

COST FACTOR (CF)

The lower the CF
the better the loan:

| Cost Factor |
|-------------|
| 650 |



LOAN PRICE RATING Lower Is Better

6.50

