Preventing Future Economic Crises through Consumer Protection Law or How the Truth in Lending Act Failed the Subprime Borrowers

available at

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1531781

forthcoming in the Ohio State Law Journal

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My Theses

- Existing disclosure laws failed to convey to subprime borrowers their payment obligations.
- Consequently, many borrowers unwittingly assumed payment obligations they could not discharge, leading to defaults and the Great Recession.
- Better consumer protection laws could have prevented that from occurring.

How Did Consumer Protection Laws Fail?

- The disclosures were misleading.
- The disclosures did not cause consumers to withdraw from bad loans for a variety of reasons.

Legal Background

- The Truth in Lending Act, 15 U.S.C. 1601 et seq., first enacted in 1968 and amended from time to time since then, together with its implementing regulation, Regulation Z, 12 C.F.R. Part 226, as interpreted by the Official Fed Commentary, lays out the disclosure requirements for consumer credit.

When Do You Get TILA Disclosures?

- Early disclosures:
  - For adjustable rate loans: booklet and program disclosures
  - For certain loans: Good Faith Estimates (circumstances under which borrowers receive these disclosures has been expanded since the subprime lending debacle)
- Later disclosures:
  - Until July 30, 2009, borrowers received final disclosures at closing
  - Under the Mortgage Disclosure Improvement Act, effective July 30, 2009, borrowers receive final disclosures three days before closing

Program Disclosures (provided at outset) From 12 CFR Part 226 App. H:

- [For example, on a $ 10,000 [term] loan with an initial interest rate of ---- [(the rate shown in the interest rate column below for the year 19 ----)] [(in effect (month) (year)], the maximum amount that the interest rate can rise under this program is ---- percentage points, to ---- %, and the monthly payment can rise from a first-year payment of $ ---- to a maximum of $ ---- in the ----- year. To see what your payments would be, divide your mortgage amount by $ 10,000; then multiply the monthly payment by that amount. (For example, the monthly payment for a mortgage amount of $ 60,000 would be: $ 60,000 / $ 10,000 = 6; 6 x ---- = $ ---- per month.)]

Program Disclosures (provided at outset) From 12 CFR Part 226 App. H:

- The example below shows how your payments would have changed under this ARM program based on actual changes in the index from 1982 to 1996. This does not necessarily indicate how your index will change in the future.

  The example is based on the following assumptions:
- Amount $ 10,000 Term---------Change date---------Payment adjustment (frequency) Interest adjustment (frequency) [Margin] fn*---------Caps ----- [periodic interest rate cap]-----[lifetime interest rate cap-----[payment cap] [Interest rate carryover] [Negative amortization] [Interest rate discount] fn**Index.......(identification of index or formula)

Program Disclosures (provided at outset) From 12 CFR Part 226 App. H:

- fn* This is a margin we have used recently, your margin may be different.

  fn** This is the amount of a discount we have provided recently; your loan may be discounted by a different amount.]

TILA Commentary ¶ 226.17(c)(1)-8, 12 C.F.R. Part 226 Supplement I

8. *Basis of disclosures in variable-rate transactions*. The disclosures for a variable rate transaction must be given for the full term of the transaction and must be based on the terms in effect at the time of consummation. Creditors should base the disclosures only on the initial rate and should not assume that this rate will increase. For example, in a loan with an initial rate of 10 percent and a 5 percentage points rate cap, creditors should base the disclosures on the initial rate and should not assume that this rate will increase 5 percentage points

TRUTH-IN-LENDING DISCLOSURE STATEMENT

(THIS IS NEITHER A CONTRACT NOR A COMMITMENT TO LEND)
For use with Adjustable Rate Mortgage Loans

☐ Preliminary ☒ Final

LENDER OR LENDER'S AGENT: [redacted]

DATE: 11/16/2006
LOAN NO.: [redacted]
Type of Loan: Conventional

BORROWERS: [redacted]

PROPERTY: [redacted]

Disclosures are estimates based on an anticipated funding date of 11/21/2006.

ANNUAL PERCENTAGE RATE	FINANCE CHARGE	Amount Financed	Total of Payments
The cost of your credit as a yearly rate	The dollar amount the credit will cost you	The amount of credit provided to you or on your behalf	The amount you will have paid after you have made all payments as scheduled
10.470%	$ 593,273.08	$ 185,134.10	$ 778,407.18

PAYMENT SCHEDULE:

NUMBER OF PAYMENTS	AMOUNT OF PAYMENTS	PAYMENTS ARE DUE Monthly BEGINNING	NUMBER OF PAYMENTS	AMOUNT OF PAYMENTS	PAYMENTS ARE DUE Monthly BEGINNING
24	$1,759.25	1/1/2007			
335	$1,715.37	1/1/2009			
1	$173,536.23	12/1/2036			

DEMAND FEATURE: ☒ This loan does not have a Demand Feature. ☐ This loan has a Demand Feature as follows:

VARIABLE RATE FEATURE:
☒ This Loan has a Variable Rate Feature. Variable Rate Disclosures have been provided to you earlier.

INSURANCE: The following is required to obtain credit:
☒ Property Insurance ☐ Flood Insurance
You may obtain the insurance from anyone you want that is acceptable to the creditor.

SECURITY: You are giving a security interest in:
☐ The property being purchased, including fixtures, leases, and rents derived from the property.
☒ The property you already own, including fixtures, leases and rents derived from the property.

ASSUMPTION: Someone buying your home
☒ may, subject to conditions, be allowed to assume the remainder of the mortgage on the original terms.
☐ cannot assume the remainder of the mortgage on the original terms.

LATE CHARGES: If your payment is more than 15 days late, you will be charged a late charge of 5.000 % of the overdue payment.

PREPAYMENT: If you pay off your loan early, you
☒ may ☐ will not have to pay a penalty
☐ may ☒ will not be entitled to a refund of part of the finance charge

See your contract documents for any additional information regarding non-payment, default, required repayment in full before scheduled date, and prepayment refunds and penalties.
e means estimate

I/We hereby acknowledge reading and receiving a complete copy of this disclosure.

[redacted]

LUCE FRAZILE [redacted] BORROWER/DATE [redacted] BORROWER/DATE

BORROWER/DATE BORROWER/DATE

4. INTEREST RATE AND MONTHLY PAYMENT CHANGES

(A) Change Dates

The interest rate I will pay may change on the first day of June, 2008 , and on that day every sixth month thereafter. Each date on which my interest rate could change is called a "Change Date."

(B) The Index

Beginning with the first Change Date, my interest rate will be based on an Index. The "Index" is the average of interbank offered rates for six-month U.S. dollar-denominated deposits in the London market ("LIBOR"), as published in The Wall Street Journal. The most recent Index figure available as of the date 45 days before the Change Date is called the "Current Index."

If at any point in time the Index is no longer available, the Note Holder will choose a new index that is based upon comparable information. The Note Holder will give me notice of this choice.

(C) Calculation of Changes

Before each Change Date, the Note Holder will calculate my new interest rate by adding six percentage point(s) (6.000 %) to the Current Index. The Note Holder will then round the result of this addition to the nearest one-eight of one percent (0.125%). Subject to the limits stated in Section 4(D) below, this rounded amount will be my new interest rate until the next Change Date. The Note Holder will then determine the amount of the monthly payment that would be sufficient to repay the unpaid principal that I am expected to owe at the Change Date in full on the Maturity Date at my new interest rate in substantially equal payments. The result of this calculation will be the new amount of my monthly payment.

(D) Limits on Interest Rate Changes

The interest rate I am required to pay at the first Change Date will not be greater than 8.300 % or less than 6.300%. Thereafter, my interest rate will never be increased or decreased on any single Change Date by more than One percentage point(s) 1.000%) from the rate of interest I have been paying for the preceding six months. My interest rate will never be greater than 12.300 % or less than 6.300 %.

(E) Effective Date of Changes

My new interest rate will become effective on each Change Date. I will pay the amount of my new monthly payment beginning on the first monthly payment date after the Change Date until the amount of my monthly payment changes again.

(F) Notice of Changes

The Note Holder will deliver or mail to me a notice of any changes in my interest rate and the amount of my monthly payment before the effective date of any change. The notice will include information required by law to be given me and also the title and telephone number of a person who will answer any question I may have regarding the notice.

ADJUSTABLE RATE RIDER

(LIBOR Six-Month-Index (As Published in the Wall Street Journal)- Rate Caps)

THIS ADJUSTABLE RATE RIDER is made this 24th day of May , 2004 and is incorporated into and shall be deemed to amend and supplement the Mortgage, Deed of Trust or Security Deed (the "Security Instrument") of the same date given by the undersigned (the "Borrower") to secure Borrower's Adjustable Rate Note (the "Note") to [redacted] (the "Lender") of the same date and covering the property described in the Security Instrument and located at:

[redacted]

[Property Address]

THE NOTE CONTAINS PROVISIONS ALLOWING FOR CHANGES IN THE INTEREST RATE AND THE MONTHLY PAYMENT. THE NOTE LIMITS THE AMOUNT THE BORROWER'S INTEREST RATE CAN CHANGE AT ANY ONE TIME AND THE MAXIMUM RATE THE BORROWER MUST PAY.

ADDITIONAL COVENANTS. In addition to the covenants and agreements made in the Security Instrument, Borrower and Lender further covenant and agree as follows:

A. INTEREST RATE AND MONTHLY PAYMENT CHANGES

The Note provides for an initial interest rate of 6.300 %. The Note provides for changes in the interest rate and the monthly payments, as follows:

4. INTEREST RATE AND MONTHLY PAYMENT CHANGES

(A) Change Dates

The interest rate I will pay may change on the first day of June, 2006 , and on that day every sixth month thereafter. Each date on which my interest rate could change is called a "Change Date."

(B) The Index

Beginning with the first Change Date, my interest rate will be based on an Index. The "Index" is the average of interbank offered rates for six-month U.S. dollar-denominated deposits in the London market ("LIBOR"), as published in the Wall Street Journal. The most recent Index figure available as of the date 45 days before each Change Date is called the "Current Index."

If the Index is no longer available, the Note Holder will choose a new index which is based upon comparable information. The Note Holder will give me notice of this choice.

Initials_______________

Loan Number: [redacted]

[redacted]

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(C) Calculation of Changes
Before each Change Date, the Note Holder will calculate my new interest rate by adding six percentage points (6.000 %) to the Current Index. The Note Holder will then round the result of this addition to the nearest one-eighth of one percentage point (0.125%). Subject to the limits stated in Section 4(D) below, this rounded amount will be my new interest rate until the next Change Date.

The Note Holder will then determine the amount of the monthly payment that would be sufficient to repay the unpaid principal that I am expected to owe at the Change Date in full on the maturity date at my new interest rate in substantially equal payments. The result of this calculation will be the new amount of my monthly payment.

(D) Limits on Interest Rate Changes
The interest rate I am required to pay at the first Change Date will not be greater than 8.300% or less than 6.300%. Thereafter, my interest rate will never be increased or decreased on any single Change Date by more than One(1.000 %) from the rate of interest I have been paying for the preceding six months. My interest rate will never be greater than 12.300)% or less than 6.300)%.

(E) Effective Date of Changes
My new interest rate will become effective on each Change Date. I will pay the amount of my new monthly payment beginning on the first monthly payment date after the Change Date until the amount of my monthly payment changes again.

(F) Notice of Changes
The Note Holder will deliver or mail to me a notice of any changes in my interest rate and the amount of my monthly payment before the effective date of any change. The notice will include information required by law to be given me and also the title and telephone number of a person who will answer any question I may have regarding the notice.

B. TRANSFER OF THE PROPERTY OR A BENEFICIAL INTEREST IN BORROWER
Section 18 of the Security Instrument is amended to read as follows:

Transfer of the Property or a Beneficial Interest in Borrower. As used in this Section 18, "Interest in the Property" means any legal or beneficial interest in the Property, including, but not limited to, those beneficial interests transferred in a bond for deed, contract for deed, installment sales contract or escrow agreement, the intent of which is the transfer of title by Borrower at a future date to a purchaser.

Initials________________

Loan Number: [redacted]

[redacted]

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One Sentence:

The Note Holder will then determine the amount of the monthly payment that would be sufficient to repay the unpaid principal that I am expected to owe at the Change Date in full on the Maturity Date at my new interest rate in substantially equal payments.

Mortgage Disclosure Improvement Act of 2008

- Lenders must provide "worst-case" scenario showing what payments would be if interest rates went to highest amount under note.
- Won't take effect until Fed promulgates implementing regulations. Fed proposed regulations last summer. The Fed's proposal, based on consumer testing, provides for disclosures that are much easier to understand.
- Effective 1/1/2010, RESPA disclosure forms (HUD-1) provided at closing state maximum monthly payment on page 3

Additional Reasons to Believe Consumers Didn’t Understand Their Payment Obligations

- Lots of anecodotal reports in the media about consumers surprised by their loan terms, especially when adjustable loans reset with higher rates, increasing payments
- 2007 FTC study of Truth in Lending