~~12 U.S.C. 5532(b)(2). As discussed in the section-by-section analysis for proposed §§ 1026.20(d) and 1026.41, the Bureau is proposing model forms for ARM interest rate adjustment notices and periodic statements. As discussed in this notice, the Bureau is proposing these model forms pursuant to its authority under DFA section 1032(b)(1) .~~

~~*Dodd-Frank Act section 1405(b).* Section 1405(b) of the Dodd-Frank Act provides that, "[n]otwithstanding any other provision of [title 14 of the Dodd-Frank Act], in order to improve consumer awareness and understanding of transactions involving residential mortgage loans through the use of disclosures, the Bureau may, by rule, exempt from or modify disclosure requirements, in whole or in part, for any class of residential mortgage loans if the Bureau determines that such exemption or modification is in the interest of consumers and in the public interest." 15 U.S.C. 1601 note. Section 1401 of the Dodd-Frank Act, which amends TILA section 103(cc), 15 U.S.C. 1602(cc), generally defines residential mortgage loan as any consumer credit transaction that is secured by a mortgage on a dwelling or on residential real property that includes a dwelling other than an open-end credit plan or an extension of credit secured by a consumer's interest in a timeshare plan. Notably, the authority granted by section 1405(b) applies to "disclosure requirements" generally, and is not limited to a specific statute or statutes. Accordingly, DFA section 1405(b) is a broad source of authority to modify the disclosure requirements of TILA.~~

~~In developing proposed rules for residential mortgage loans under Dodd-Frank Act section 1405(b) for this proposal, the Bureau has considered the purposes of improving consumer awareness and understanding of transactions involving residential mortgage loans through the use of disclosures, and the interests of consumers and the public. For the reasons discussed in this notice, the Bureau is proposing portions of this rule pursuant to its authority under Dodd-Frank Act section 1405(b).~~

~~*See* the section-by-section analysis for each proposed section for further elaboration on legal authority.~~

VI. Section-by-Section Analysis

A. Regulation Z

Section 1026.17 General Disclosure Requirements

17(a) Form of Disclosures

17(a)(1)

Section 1026.17(a)(1) contains form requirements generally applicable to disclosures under subpart C. The Bureau proposes to make certain modifications to these requirements as applicable to the ARM interest rate adjustment payment change notices under proposed § 1026.20(c) and the initial ARM interest rate adjustment notices under proposed § 1026.20(d).

Section 1026.17(a) requires, among other things, that certain disclosures contain only information directly related to that disclosure. Current § 1026.20(c) is not included in the list of disclosures subject to this requirement. Further, commentary to § 1026.17(a)(1) states that the disclosures required by current § 1026.20(c) are not subject to the general segregation requirements under § 1026.17(a)(1).

The payment change notice proposed by § 1026.20(c) is intended to inform consumers of upcoming changes to their interest rate and mortgage payments and to give them time to explore alternatives. The Bureau does not believe that the form requirements applicable to current § 1026.20(c) notices are sufficient to highlight and emphasize important information consumers need to make decisions about their adjustable-rate mortgages. Presenting information to consumers separate from other information enhances consumers' awareness of the material. Therefore, the Bureau proposes to amend § 1026.17(a)(1) and comment 17(a)(1)-2.ii to add proposed § 1026.20(c) to the enumerated disclosures required to contain only information directly related to the disclosure and to require that proposed § 1026.20(c) disclosures be grouped together and segregated from everything else.

Other § 1026.17(a)(1) requirements, such as that disclosures be clear and conspicuous, in writing, and provided electronically subject to compliance with Electronic Signatures in Global and National Commerce Act (E-Sign Act)(15 U.S.C. 7001 et seq.), would continue to apply to § 1026.20(c).

TILA section 128A provides that the initial ARM interest rate adjustment notices, which the Bureau proposes to implement in proposed § 1026.20(d), be "separate and distinct from all other correspondence to the consumer." Accordingly, the Bureau proposes to revise § 1026.17(a), to make clear that the proposed § 1026.20(d) disclosures are not subject to the general segregation requirement under that section but rather, pursuant to proposed § 1026.20(d), are required to be separate and distinct from all other correspondence. *See* comment 20(d) for further discussion of the separate and distinct requirement. Other requirements of § 1026.17(a), such as that disclosures be clear and conspicuous, in writing, and provided electronically subject to compliance with the E-Sign Act, would apply to the proposed § 1026.20(d) disclosures.

The proposed application of § 1026.17(a)(1), as modified, to proposed § 1026.20(c) and (d) is authorized, in part, under TILA section 122, which requires that disclosures under TILA be clear and conspicuous, in accordance with regulations of the Bureau. The requirements are further authorized under TILA section 105(a) because the Bureau believes that the proposed form requirements are necessary and proper to effectuate the purposes of TILA to assure a meaningful disclosure of credit terms, avoid the uninformed use of credit, and protect consumers against inaccurate and unfair credit billing practices by ensuring that consumers understand the content of the proposed ARM notices. Moreover, as discussed below, the disclosures proposed under § 1026.20(c) are authorized, among other provisions, under TILA section 128(f)(2), which authorizes the Bureau to develop and prescribe a standard form for the disclosures required under TILA section 128(f).

As to proposed § 1026.20(d) disclosures, DFA section 1418, TILA section 128A(b) specifically provides that the disclosures shall be in writing, separate and distinct from all other correspondence. In addition, the Bureau believes, consistent with DFA section 1032(a), that the proposed application of § 1026.17(a)(1), as modified, to § 1026.20(d) will ensure that the features of ARM loans are effectively disclosed to consumers in a manner that allows consumers to understand the information disclosed. The Bureau further believes, consistent with DFA section 1405(a), that it is proper to modify DFA section 1418 to apply the form requirements in proposed § 1026.17(a)(1) to improve consumer awareness and understanding of ARM adjustments.

17(b) Time of Disclosures

The Bureau is proposing to revise § 1026.17(b) to add proposed § 1026.20(d) to the list of variable-rate disclosure provisions with special timing requirements. This proposed amendment would alert creditors, assignees, and servicers that, as with proposed § 1026.20(c) payment adjustment notices, there are timing requirements particular to the proposed § 1026.20(d) initial interest rate adjustment notices.

17(c) Basis of Disclosures and Use of Estimates

17(c)(1)

Section 1026.17(c)(1) requires disclosures to reflect the terms of the legal obligation between the parties. Current comment 17(c)(1)-1 provides that, under this requirement, disclosures generally must reflect the credit terms to which the parties are legally bound as of the outset of the transaction, but that in the case of disclosures required under § 1026.20(c), the disclosures shall reflect the credit terms to which the parties are legally bound when the disclosures are provided. The Bureau proposes revising comment 17(c)(1)-1 to make clear that the disclosures required under proposed § 1026.20(d), like those under proposed § 1026.20(c), shall reflect the credit terms to which the parties are legally bound when the disclosures are provided, rather than at the outset of the transaction.

Section 1026.18 Content of Disclosures

18(f) Variable Rate

18(f)-1

Current comment 18(f)-1 clarifies that creditors electing to substitute § 1026.19(b) disclosures for § 1026.18(f)(1) disclosures, as permitted by § 1026.18(f)(1) and (3), may, but need not, also provide disclosures required by current § 1026.20(c). Under current § 1026.20(c), disclosures are permissive in such cases because the § 1026.19(b) substitution is only permitted for variable-rate transactions not secured by the consumer's principal dwelling or variable-rate transactions secured by the consumers' principal dwelling, but with a term of one year or less. These transactions are not covered by current § 1026.20(c). Thus, current comment 18(f)-1 does not alter the legal requirements applicable to creditors. The clarification was, however, helpful because current § 1026.20(c) cross-references § 1026.19(b) and applies to transactions covered by § 1026.19(b).

The Bureau proposes to delete this reference to § 1026.20(c) from the comment because it is no longer helpful since neither proposed § 1026.20(c) nor (d) cross-references § 1026.19(b) and those proposed provisions define their scope of coverage without reference to § 1026.19(b). Moreover, proposed § 1026.20(c) or (d) apply to some ARMs with terms of one year or less such that applying the current comment would create an unwarranted exception to the requirement to provide ARM notices to consumers with those types of ARMs. For these reasons, the Bureau proposes to delete the reference to § 1026.20(c) in comment 18(f)-1.

Section 1026.19 Certain Mortgage and Variable-Rate Transactions

19(b) Certain Variable Rate Transactions

19(b)-4 Other Variable-Rate Regulations

The Bureau proposes revising comment 19(b)-4 to delete reference to current § 1026.20(c) and (d). Current comment 19(b)-4 explains that transactions in which the creditor is required to comply with and has complied with the disclosure requirements of the variable-rate regulations of other Federal agencies are exempt from the requirements of § 1026.20(c) by virtue of current § 1026.20(d). Consistent with the proposed deletion of current § 1026.20(d), the Bureau proposes revising comment 19(b)-4 to delete reference to current § 1026.20(c) and (d).

19(b)-5.i.C Certain Mortgage and Variable-Rate Transactions

The Bureau proposes revising comment 19(b)-5.i.C to cross-reference other commentary that makes clear that proposed § 1026.20(c) and (d) do not apply to "price-level-adjusted mortgages" that have a fixed-rate of interest but provide for periodic adjustments to payments and the loan balance to reflect changes in an index measuring prices or inflation.

19(b)(2)(xi)-1 Adjustment Notices

Pursuant to current § 1026.19(b)(2)(xi), disclosures regarding the type of information that will be provided in notices of interest rate adjustments and the timing of such notices must be provided to consumers applying for variable-rate transactions secured by the consumer's principal dwelling with a term greater than one year. Current comment 19(b)(2)(xi)-1 clarifies that these disclosures include information regarding the content and timing of disclosures consumers will receive pursuant to current § 1026.20(c). The Bureau proposes adding reference to proposed § 1026.20(d) to the comment, since those disclosures would be provided to consumers under the Bureau's proposed rule. The proposed comment also makes conforming changes to the text suggested for describing the ARM notices to reflect the timing and content of the disclosures proposed by § 1026.20(c) and (d).

Section 1026.20 Subsequent Disclosure Requirements

20(c) Rate Adjustments

Current § 1026.20(c) requires that disclosures be provided to consumers with variable-rate mortgages each time an adjustment results in a corresponding payment change and at least once each year during which an interest rate adjustment is implemented without a corresponding payment change.

The current rule does not differentiate between the content required for the annual notice and the notices required each time the interest rate adjustment results in a corresponding payment change. Current § 1026.20(c) requires that adjustment notices disclose the following: (1) the current and prior interest rates for the loan; (2) the index values upon which the current and prior interest rates are based; (3) the extent to which the creditor has foregone any increase in the interest rate; (4) the contractual effects of the adjustment, including the payment due after the adjustment is made, and a statement of the loan balance; and (5) the payment, if different from the payment due after adjustment, that would be required to fully amortize the loan at the new interest rate over the remainder of the loan term.

The Bureau proposes two major changes to § 1026.20(c). First, the Bureau proposes eliminating the annual notice sent each year during which an interest rate adjustment is implemented without a corresponding payment change. As explained in more detail below, the Bureau believes that Dodd-Frank Act amendments to TILA, and the Bureau's proposed amendments to Regulation Z that would implement those provisions, would provide consumers with much of the information contained in the annual notice thereby greatly minimizing the need for its protections. Second, the proposal updates current § 1026.20(c) by adding disclosures that the Bureau believes will enhance protections for consumers with ARMs. The proposed revisions to § 1026.20(c) also harmonize with the requirements the Bureau is proposing for the initial

ARM interest rate adjustment notice under § 1026.20(d), thereby promoting consistency between the Regulation Z ARM provisions.

Elimination of annual disclosure. First, proposed § 1026.20(c) eliminates the annual notice requirement under the current rule. The Bureau believes that consumers who receive the current annual notice, such as consumers with ARMs with payment caps, would receive much of the same information in the periodic statement under proposed § 1026.41, discussed below. The proposed periodic statement would provide consumers with comprehensive information about their mortgages each billing cycle. The periodic statement would include some of the same key information provided to consumers under the current § 1026.20(c) annual notice, such as the current interest rate and the date after which that rate would adjust. It also would provide other information that may be useful to consumers who would receive the § 1026.20(c) annual ARM notice, including the existence and amount of any prepayment penalty; allocation of the consumer's payment by principal, interest, and escrow; the amount of the outstanding principal; contact information for the State housing finance authority; and information to access a list of Federally-certified housing counselors.

In light of the amount, type, and frequency of the information the Bureau proposes to provide in the periodic statement to consumers with ARMs that are subject to the current § 1026.20(c) annual ARM interest rate notice, the Bureau proposes to eliminate the requirement for the annual notice as duplicative and as potentially contributing to information overload that could deflect consumer attention away from the information such consumers would receive in other required disclosures. The Bureau solicits comments on the need, value, or use of retaining the annual notice required under current § 1026.20(c) for consumers whose ARM interest rates adjust during the course of a year without resulting in corresponding payment changes.

The Bureau proposes to delete comments 20(c)(1)-1 and 20(c)(4)-1 which, among other things, address the content of the § 1026.20(c) annual notice the Bureau is proposing to eliminate. Current comment 20(c)(1)-1 also explains, among other things, the meaning of the terms "current" and "prior" rates and that in disclosing all other rates that applied during the period between notices, the creditor may disclose a range of the highest and lowest rates during that year period. Current comment 20(c)(4)-1, among other things, defines the term loan "balance" and explains that a "contractual effect" of a rate adjustment includes disclosure of any change in the term or maturity of the loan if the change resulted from the rate adjustment. The Bureau also proposes deletion of these current comments as they relate to the recurring disclosures that would be required by proposed § 1026.20(c) for interest rate adjustments resulting in a corresponding payment change. The Bureau proposes to replace these comments with the new commentary discussed below.

Amendment of payment change disclosure. Second, proposed § 1026.20(c) would amend existing § 1026.20(c) as it relates to interest rate adjustments that result in a corresponding payment change. The proposal retains much of the content required in the current notice and also would require disclosure of additional information that the Bureau believes would help consumers better understand and manage their adjustable-rate mortgages. The proposed revisions to current § 1026.20(c) harmonize with the initial ARM interest rate adjustment notice proposed by § 1026.20(d). The Bureau believes that promoting consistency between the ARM disclosure provisions of § 1026.20(c) and (d) would reduce compliance burdens on industry and minimize consumer confusion.

Creditors, assignees, and servicers. The Bureau also proposes to amend § 1026.20(c) to provide that it applies to creditors, assignees, and servicers. Current § 1026.20(c) applies to creditors and existing comment 20(c)-1 clarifies that the requirements of § 1026.20(c) also apply to subsequent holders, *i.e.*, assignees. The Bureau's proposal provides that § 1026.20(c) would apply to servicers, as well as to creditors and assignees. Proposed comment 20(c)-1 clarifies that a creditor, assignee, or servicer that no longer owns the mortgage loan or the mortgage servicing rights is not subject to the requirements of § 1026.20(c).

As discussed below, proposed § 1026.20(c) is authorized under, among other authorities, TILA section 128(f), which applies to creditors, assignees, and servicers. The proposal is consistent with proposed § 1026.20(d) such that both proposed § 1026.20(c) and (d) would apply to creditors, assignees and servicers.

The Bureau believes that applying § 1026.20(c) to creditors and assignees, but not servicers, would compromise consumers' recourse in the case of a violation of § 1026.20(c). Many creditors and assignees do not service the loans they own and instead sell the mortgage servicing rights to a third party. The servicer is the party with which consumers have contact on an ongoing basis regarding their mortgages. Consumers send their payments to the servicer and communicate with the servicer regarding any questions or problems with their mortgage that may arise. Where the owner and the servicer are different entities, consumers may not know the identity of the owner and may not even realize that the servicer is not the owner of their mortgage. Moreover, it can be difficult for consumers to ascertain the identity of the creditor or assignee, even though servicers would be required to identify the owner of a mortgage under rules proposed pursuant to DFA section 1463. Thus, in the case of a violation of proposed § 1026.20(c), consumers should be able to seek relief against the servicer as the primary party from whom they receive service and with whom they maintain communication regarding their mortgages. *See* below, section 20(d), for a discussion of application of proposed § 1026.20(d) initial ARM interest rate adjustment notices to assignees. The same rationale applies to proposed § 1026.20(c) ARM payment adjustment notices.

Proposed comment 20(c)-1 explains that any provision of subpart C that applies to the disclosures required by § 1026.20(c) also applies to creditors, assignees, and servicers. This is the case even where the other provisions of subpart C refer only to creditors. For the reasons discussed above, the Bureau proposes that the requirements of other regulations that apply to the § 1026.20(c) ARM payment adjustment notices apply to servicers as well as to creditors and assignees.

The proposal also would delete current comment 20(c)-1, which, among other things, refers to subsequent holders, in favor of consistent usage of the term assignee in proposed § 1026.20(c) and (d). It would also delete comment 20(c)-3 as duplicative of the § 1026.17(c)(1) requirement that the disclosures reflect the terms of the parties' legal obligations.

Conversions. Proposed § 1026.20(c) also applies to ARMs converting to fixed-rate mortgages when the adjustment to the interest rate results in a corresponding payment change. Providing this notice would alert consumers to their new interest rate and payment following conversion from an ARM to a fixed-rate mortgage. Proposed comment 20(c)-2 explains that, in the case of an open-end account converting to a closed-end adjustable-rate mortgage, § 1026.20(c) disclosures are not required until the implementation of the first interest rate adjustment that results in a corresponding payment change post-conversion. Under the proposed rule, this conversion is analogous to consummation. Thus, like other ARMs subject to the requirements of proposed § 1026.20(c), disclosures for these types of converted ARMs would not be required until the first interest rate adjustment following the conversion which results in a corresponding payment change. The proposed rule is consistent with existing commentary and proposed § 1026.20(d) regarding conversions. *See* current comment 20(c)-1.

Authority. The Bureau proposes to amend § 1026.20(c) pursuant to its authority under TILA section 105(a). For the reasons discussed in the section-by-section analysis for each of the proposed amendments to § 1026.20(c), the Bureau believes that the proposed amendments are necessary and proper to effectuate the purposes of TILA to assure a meaningful disclosure of credit terms, avoid the uninformed use of credit, and protect consumers against inaccurate and unfair credit billing practices. Proposed § 1026.20(c) also is authorized under TILA section 128(f), which requires that certain information enumerated in the statute be provided to consumers every billing cycle in a periodic statement and also confers on the Bureau the authority to require periodic disclosure of "[s]uch other information as the Bureau may prescribe in regulations." Proposed § 1026.20(c) is further authorized under DFA section 1405(b), which permits the Bureau to modify disclosure requirements where such modification is in the interest of consumers and the public.

Although TILA section 128(f) authorizes the Bureau to require that the content for the § 1026.20(c) ARM notices be included in the periodic statement, the Bureau believes, for the reasons set forth above and below, that consumers would be better served if this information was provided as a separate disclosure. Under proposed § 1026.17(a), the proposed § 1026.20(c) ARM payment adjustment notice would have to be provided separate and distinct from the periodic statement. The disclosures required by proposed § 1026.20(c), however, may be provided to consumers together with the periodic statement, depending on the mode of delivery, in the same envelope or as an additional attachment to the e-mail. The Bureau also believes that the interest of consumers and the public interest would be better served by receiving the § 1026.20(c) ARM notice, within the time frame discussed below, each time the ARM interest rate adjusts resulting in a corresponding payment change, rather than with each billing cycle.

20(c)(1) Coverage of Rate Adjustment Disclosures

20(c)(1)(i) In General

Proposed § 1026.20(c)(1) defines an adjustable-rate mortgage, for purposes of § 1026.20(c), as a closed-end consumer credit transaction secured by the consumer's principal dwelling in which the annual percentage rate may increase after consummation. Current § 1026.20(c) requires disclosures only for adjustments to the interest rate in variable-rate transactions subject to § 1026.19(b), which is limited to loans secured by the consumer's principal dwelling with a term of greater than one year. The Bureau proposes deleting the cross-reference to § 1026.19(b), thereby expanding the scope of proposed § 1026.20(c) to include loans with terms of one year or less. Proposed § 1026.20(c)(1)(i) would replace current § 1026.20(c) and comment 20(c)-1 with regard to which loans are subject to the interest rate adjustment disclosures.

There is one type of short-term ARM that the Bureau proposes to except from the requirements of § 1026.20(c): construction loans with terms of one year or less. *See* section 20(c)(1)(ii) below for a full discussion of this proposed exception for construction ARMs with terms of one year or less. The Bureau solicits comment on whether there are other ARMs with terms of less than one year and whether the proposed 60-day minimum notice period is appropriate for such loans. *See* section 20(c)(2) below for a full discussion of the timing proposed for § 1026.20(c). If the 60-day period is not appropriate, the Bureau solicits comment on what period would be appropriate that would also provide consumers with sufficient notice of a payment change. This proposal regarding coverage is consistent with the statutory requirements of TILA section 128A and proposed § 1026.20(d) in that those provisions generally apply to all ARMs, regardless of term length. Thus, the proposal to expand § 1026.20(c) to ARMs with terms of one year or less would harmonize the coverage of the two types of ARM adjustment notices, thereby ensuring that both § 1026.20(d) notices and § 1026.20(c) notices, when required, are provided to the same consumers.

The Bureau proposes using the terms "adjustable-rate mortgage" or "ARM" to replace the term "variable-rate transaction" in current § 1026.20(c). Proposed comment 20(c)(1)(i)-1 clarifies that the term "variable-rate transaction," as used in § 1026.19(b) and elsewhere in Regulation Z, is synonymous with the term "adjustable-rate mortgage" or "ARM", except where specifically distinguished. The Bureau proposes this revision because "adjustable-rate mortgage" or "ARM" are the terms commonly used for mortgages covered by current and proposed § 1026.20(c).

Proposed comment 20(c)(1)(i)-1 also clarifies that the requirements of § 1026.20(c)(1)(i) are not limited to transactions financing the initial acquisition of the consumer's principal dwelling, but also would apply to other closed-end ARM transactions secured by the consumer's principal dwelling, consistent with current comment 19(b)-1 and current § 1026.20(c).

20(c)(1)(ii) Exceptions

Proposed § 1026.20(c)(1)(ii) sets forth two exceptions to the disclosure requirements of § 1026.20(c). These exceptions apply to: (1) construction loans with terms of one year or less; and (2) the first adjustment to an ARM if the first payment at the adjusted level is due within 210 days after consummation and the actual, not estimated, new interest rate was disclosed at consummation, in the initial ARM interest rate adjustment notice that would be required by proposed § 1026.20(d). Proposed comments 20(c)(1)(ii)-1 and -2 provide further explanation. Proposed § 1026.20(d) also would except the same construction loans.

As discussed in more detail below in connection with the notice required for an initial ARM interest rate adjustment under § 1026.20(d), the Bureau also considered, but decided against, permitting or requiring small creditors, assignees, and servicers to include in the periodic statement the information required for the first payment change notice under proposed § 1026.20(c). The Bureau also considered this option with regard to all notices that small entities would be required to provide to consumers under proposed § 1026.20(c). As discussed further below, the Bureau solicits comments from small entities -- and from creditors, assignees, and servicers in general -- as to whether small entities or all creditors, assignees, and servicers should be permitted or required to provide the information required in the first payment change notices under proposed § 1026.20(c) in the periodic statement instead of as a separate ARM notice and whether this should be done for all § 1026.20(c) notices.

Regarding the first exception the Bureau proposes, construction loans generally have short terms of six months to one year and are subject to frequent interest rate adjustments, usually monthly or quarterly. The construction period usually involves several disbursements of funds at times and in amounts that are unknown at the beginning of that period. The consumer generally pays only accrued interest until construction is completed. The creditor, assignee, or servicer, in addition to disbursing payments in stages, closely monitors the progress of construction. Generally, at the completion of the construction, the construction loan is converted into permanent financing in which the loan amount is amortized just as in a standard mortgage transaction. *See* comment 17(c)(6)-2 for additional information on construction loans.

The frequent interest rate adjustments, multiple disbursements of funds, short loan term, and on-going communication between the creditor, assignee, or servicer and consumer, distinguish construction loans from other ARMs. These loans are meant to function as bridge financing until construction is completed and permanent financing can be put in place. Consumers with construction ARM loans are not at risk of payment shock like other ARMs where interest rates change less frequently. Moreover, given the frequency of interest rate adjustments on construction loans, creditors, assignees, or servicers would have difficulty complying with the proposed requirement to provide the notice to consumers 60 to 120 days before payment at a new level is due for each adjustment resulting in a corresponding payment change. For these reasons, providing notices under § 1026.20(c) for these loans would not provide a meaningful benefit to the consumer nor improve consumers' awareness and understanding of their construction loans with terms of one year or less. Proposed comment 20(c)(1)(i)-1 applies the standards in comment 19(b)-1 for determining the term of a construction loan.

The second exception, for the first adjustment to an ARM causing a payment change if the first payment at the adjusted level is due within 210 days after consummation, would apply only if the exact interest rate, not an estimate, is disclosed at consummation. For ARMs adjusting within six months of consummation, *i.e.*, 210 days before the first payment is due at the new level, the disclosures proposed by § 1026.20(d) must be provided at consummation. The recency of consummation obviates the need for the § 1026.20(c) notice in this circumstance because consumers would have been apprised of the upcoming adjustment and payment change just months prior to its occurrence and their mortgages would be so new as to not require the alerts in the notice regarding pursuing alternatives. Thus, providing § 1026.20(c) disclosures in these circumstances would be duplicative, not contribute to consumer awareness and understanding, and not provide a meaningful benefit to consumers.

Proposed comment 20(c)(1)(ii)-3 discusses other loans to which the proposed rule does not apply. Proposed comment 20(c)(1)(ii)-3 is consistent with proposed comment 20(d)(1)(ii)-2 with regard to the loans which are not subject to the proposed ARM disclosure rules. Certain Regulation Z provisions treat some of these loans as variable-rate transactions, even if they are structured as fixed-rate transactions. The proposed comment clarifies that, for purposes of § 1026.20(c), the following loans, if fixed-rate transactions, are not ARMs and therefore not subject to ARM notices pursuant to § 1026.20(c): shared-equity or shared-appreciation mortgages; price-level adjusted or other indexed mortgages that have a fixed rate of interest but provide for periodic adjustments to payments and the loan balance to reflect changes in an index measuring prices or inflation; graduated-payment mortgages or step-rate transactions; renewable balloon-payment instruments; and preferred-rate loans. The particular features of these types of loans may trigger interest rate or payment changes over the term of the loan or at the time the consumer pays off the final balance. However, these changes are based on factors other than a change in the value of an index or a formula. Because the enumerated loans are not ARMs they are not covered by proposed § 1026.20(c) and require no disclosures under this section.

Proposed and current § 1026.20(c) are generally consistent with regard to the ARMs to which they do not apply. The principal difference is that current § 1026.20(c) does apply to renewable balloon-payment instruments and preferred-rate loans, even if they are structured as fixed-rate transactions while proposed § 1026.20(c) would not apply to such loans. *See* § 1026.19(b) and comment 19(b)-5.i.A and B. Also, as discussed above, current § 1026.20(c) does not apply to loans with terms of one year or less. This category includes construction loans, which are excepted from coverage under proposed § 1026.20(c). Logically, the Bureau's proposed exception for initial § 1026.20(c) ARM adjustments if the first payment at the adjusted level is due within 210 days of consummation is inapplicable to the current rule since proposed § 1026.20(d) is not yet implemented to replace the current § 1026.20(c) disclosures provided at consummation.

Like proposed comment 20(c)(1)(ii)-3, current comment 20(c)-2 clarifies that § 1026.20(c) does not apply to shared-equity or shared-appreciation mortgages or to price-level adjusted or other such indexed mortgages. The current rule cross-references § 1026.19(b) and applies to all variable-rate transactions covered by that rule. Comment 19(b)-4 explains that graduated-payment mortgages and step-rate transactions without variable-rate features are not subject to § 1026.19(b). Therefore, like the proposed rule, such loans are not subject to current § 1026.20(c).

The current rule does not mention renewable balloon-payment instruments and preferred-rate loans, but current § 1026.20(c) applies to these loan products through the rule's cross-reference to § 1026.19(b) and therefore to comment 19(b)-5.i.A and B. As discussed above, these loans are not adjustable-rate mortgages and the Bureau does not believe that it is appropriate to require the disclosures in proposed § 1026.20(c) for such loans. The particular features of these types of loans may trigger interest rate or payment changes over the term of the loan or at the time the consumer pays off the final balance. However, these changes are based on factors other than a change in the value of an index or a formula. For example, whether or when the interest rate will adjust for a preferred-rate loan with a fixed interest rate is likely not knowable to the creditor, assignee, or servicer 60 to 120 days in advance of the due date for the first payment at a new level after the adjustment. This is because the loss of the preferred rate is based on factors other than a formula or change in the value of an index agreed to at consummation. Like the Bureau's proposed rule, the Board also proposed to remove renewable balloon-payment instruments and preferred-rate loans from coverage under § 1026.20(c) in its 2009 Closed-End Proposal.[62]

20(c)(2) Timing and Content of Rate Adjustment Disclosures

Proposed § 1026.20(c)(2) would require that ARM disclosures be provided to consumers 60 to 120 days before payment at a new level is due. Under current § 1026.20(c), notices must be provided to consumers 25 to 120 days before payment at a new level is due. Thus, the proposed rule would increase the minimum advance notice to consumers from 25 to 60 days before a new payment amount is due. There are two circumstances under which the rule proposes a different time frame, which are discussed below. Proposed comment 20(c)(2)-1 would replace current comment 20(c)-1 regarding timing.

[62] 74 FR 43232, 43264, 43387 (Aug. 26, 2009).

Current and proposed § 1026.20(c) disclosures provide consumers with their actual new interest rate and payment. The disclosures proposed by § 1026.20(d) likely would provide estimates of these amounts. The longer time frame proposed by the rule is intended to give consumers adequate time to refinance or take other actions based on these exact amounts, if they are not able to make higher payments. The current minimum time of 25 days does not give consumers sufficient time to pursue meaningful alternatives such as refinancing, home sale, loan modification, forbearance, or deed in lieu of foreclosure. In the current market, "it now takes the nation's biggest mortgage lenders an average of more than 70 days to complete a refinance.[63] Even if consumers elect not to refinance or pursue other alternatives, the proposed rule would give them more time to adjust their finances to the actual amount of an increase in their mortgage payments.

The Bureau believes that for most adjustable-rate mortgages, the proposed 60-day minimum time frame would provide sufficient time for creditors, assignees, and servicers to comply with the proposed rule. Through outreach to servicers of adjustable-rate mortgages it appears that, for most ARMs, servicers know the index value from which the new interest rate and payment are calculated at least 45 days before the date of the interest rate adjustment. Because interest generally is paid one month in arrears, this mean that, for most ARMs, servicers know the index value approximately 75 days before the due date of the first new payment, depending on the number of days in the month during which interest begins accruing at the new rate.

Creditors, assignees, and servicers generally refer to the date the adjusted interest rate goes into effect as the "change date." The "look-back period" is the number of days prior to the change date on which the index value will be selected which serves as the basis for the new interest rate and payment. In general, interest rate change dates occur on the first of the month to correspond with payment due dates. Thus, the due date for the new payment generally falls on the first of the month following the change date.

Based on outreach conducted by the Bureau, it appears that small servicers often send out the payment change notices required by § 1026.20(c) on the same day the index value is selected. In that case, for a loan with a 45-day look-back period, the notice is ready 45 days before the change date and, with an approximately 30-day billing cycle between the change date and the date payment at the new level is due, the interest rate adjustment notice can be provided to the consumer approximately 75 days before the new payment is due. Under these circumstances, the servicer could comfortably comply with a rule requiring that notice be provided to consumers 60 days before the payment at a new level is due.

On the other hand, many large creditors, assignees, or servicers conduct what is referred to as a "verification period" before sending out the notices required by § 1026.20(c). This verification period generally takes anywhere from three to ten days and involves confirming the index rate and other quality control measures to insure the notices are correct.[64] In these cases, for a loan with a 45-day look-back period, the payment change notices can be provided between approximately 42 and 35 days prior to the change date, which is either 70 to 73 or 63 to 66 days

[63] Timiraos & Simon, *supra* note 52.
[64] No creditor, assignee, or servicer contacted by the Bureau used a system employing an automatic feed of information from the publisher of an index source. All data was entered and verified manually.

before the new payment is due, depending on the verification period used and the length of the billing cycle. Under these circumstances, payment change notices could be provided to consumers within the 60-day period, even assuming a verification period of up to thirteen days. For loans with the shortest verification period of three days, the payment change notice could be provided to consumers within 70 days prior to payment due at a new level.

In sum, it appears that for most ARMs, creditors, assignees, or servicers could comply with the 60-day time period proposed by the Bureau. The Bureau solicits comment about this proposed timing of the § 1026.20(c) notice.

Some ARMs have look-back periods shorter than 45 days. For example, ARMs backed by the FHA and VA often have look-back periods of 15 or 30 days. For some ARMs, the calculation date is the first business day of the month that precedes the effective date of the interest rate change. Since the first day of that month may not fall on a business day, the look-back period may be less than 30 days, excluding any verification period.

In two circumstances, the Bureau is proposing a different time period from the proposed 60 to 120 days. The Bureau proposes that existing ARMs with look-back periods of less than 45 days that were originated before a specified date provide the notices required under this proposed rule within 25 to 120 days before payment at a new level is due. The Bureau proposes that the specified date be July 21, 2013. The Bureau understands that the creditors, assignees, or servicers of such loans would not be able to comply with the 60- to 120-day time frame proposed in § 1026.20(c). Although this time frame would shorten the advance notice provided to some consumers, the Bureau is proposing to grandfather these ARMs in order to prevent altering existing contractual agreements regarding the look-back period. Thus, going forward, ARMs must be structured to permit compliance with the proposed 60- to 120-day time frame. The Bureau solicits comment on whether it should grandfather existing ARMs with look-back periods of less than 45 days. The Bureau also seeks comment on whether July 21, 2013 is an appropriate time frame for grandfathering existing ARMs with look-back periods of less than 45 days or if another time period would be more appropriate and why. If not, the Bureau seeks comment on what would be an appropriate time frame for the expiration of the grandfathering period. The Bureau also solicits comments on whether other adjustable-rate mortgages should be allowed to continue with a 25- to 120- day period.

The Bureau also proposes to alter the timing requirements for ARMs that adjust for the first time within 60 days of consummation where the actual, not estimated, new interest rate was *not* disclosed at consummation. (If the actual interest rate was disclosed at consummation, such loans would be excepted from the rule pursuant to proposed § 1026.20(c)(1)(ii)). The creditors, assignees, or servicers of such loans would not be able to comply with the proposed 60-day time frame. For such loans, the disclosures proposed by § 1026.20(c) must be provided to consumers as soon as practicable, but not less than 25 days before a payment at a new level is due.

The Bureau solicits comment about the feasibility of applying the proposed 60-day period to ARMs that have look-back period of less than 45 days. The Bureau solicits comments about whether a look-back period of 45 days or longer is feasible going forward for loans that currently use shorter look-back periods and, if not, why not. The Bureau solicits comments on the extent, if any, to which the relative length of the look-back period may affect the interest rate risk for the creditor, assignee, or servicer.

For all ARMs, the Bureau solicits comments on the operational changes that would be required to provide § 1026.20(c) notices at least 60 days before payment at a new level is due. Comment is requested on any factors that would hinder compliance with this time frames. In light of technological and other advances since the promulgation of current § 1026.20(c) in 1987, the Bureau also solicits comment on whether, and if so why, lengthy verification periods are necessary and on the feasibility of reducing the length of these verification periods.

20(c)(2)(i) Statement Regarding Changes to Interest Rate and Payment

For interest rate adjustments resulting in corresponding payment changes, proposed § 1026.20(c)(2)(i)(A) would inform consumers that, under the terms of their adjustable-rate mortgage, the specific period in which their interest rate stayed the same will end on a certain date and that their interest rate and mortgage payment will change on that date. This disclosure is similar to the pre-consummation disclosures provided to consumers pursuant to current § 1026.19(b)(2)(i) and § 1026.37(i) as recently proposed by the 2012 TILA-RESPA Proposal.

Under proposed § 1026.20(c)(2)(i)(B), the creditor, assignee, or servicer must include in the disclosure the date of the impending and future interest rate adjustments. Proposed § 1026.20(c)(2)(i)(C) would require disclosure of any other changes to the loan taking place on the same day of the rate adjustment, such as changes in amortization caused by the expiration of interest-only or payment-option features.

The first ARM model form tested did not contain the proposed statement informing consumers of impending and future changes to their interest rate and the basis for these changes. Although participants understood that their interest rate was adjusting and this would affect their payment, they did not understand that these changes would occur periodically subject to the terms of their mortgage contract. Inclusion of this statement in the second round of testing successfully resolved this confusion. All but one consumer tested in round two and three of testing understood that, under the scenario presented to them, their interest rate would change annually.[65]

20(c)(2)(ii) Table with Current and New Interest Rates and Payments

Proposed § 1026.20(c)(2)(ii) would require disclosure of the following information in the form of a table: (A) the current and new interest rates; (B) the current and new periodic payment amounts and the date the first new payment is due; and (C) for interest-only or negatively-amortizing payments, the amount of the current and new payment allocated to interest, principal, and property taxes and mortgage-related insurance, as applicable. The information in this table would appear within the larger table containing all the required disclosures.

This table would follow the same order as, and have headings and format substantially similar to, those in the table in Forms H-4(D)(1) and (2) in Appendix H of subpart C. The Bureau learned through consumer testing that, when presented with information in a logical order, consumers more easily grasped the complex concepts contained in the proposed § 1026.20(c) notice. For example, the form begins by informing consumers of the basic purpose of the notice: their interest rate is going to adjust, when it will adjust, and the adjustment will change their mortgage payment. This introduction is immediately followed by a visual illustration of this information in the form of a table comparing consumers' current and new

[65] Macro Report, *supra* note 38, at vii.

interest rates. Based on consumer testing, the Bureau believes that consumer understanding is enhanced by presenting the information in a simple manner, grouped together by concept, and in a specific order that allows consumers the opportunity to build upon knowledge gained. For these reasons, the Bureau proposes that creditors, assignees, or servicers disclose the information in the table as set forth in Forms H-4(D)(1) and (2) in Appendix H.

Proposed § 1026.20(c)(2)(ii) replaces current § 1026.20(c)(1) and (4), but retains the obligation to disclose the current and new interest rates and the amount of the new payment. Proposed § 1026.20(c)(2)(ii)(A) also would require disclosure of the date when the consumer must start paying the new payment and proposed comment § 1026.20(c)(2)(ii)(A)-1 clarifies that the new interest rate must be the actual rate, not an estimate. Proposed rule § 1026.20(c)(2)(ii) also replaces the language "prior" and "current" in the current rule with the terms "current" and "new," respectively, and deletes comment 20(c)(2)-1 which, among other things, uses the terms "prior" and "current." This change is designed to make clear that "current" means the interest rate and payment in effect prior to the interest rate adjustment and "new" means the interest rate and payment resulting from the interest rate adjustment.

Proposed comment 20(c)(2)(ii)(A)-1 defines the term "current" interest rate as the one in effect on the date of the disclosure. This more succinct definition replaces the lengthy definition of "prior interest rates" in current comment 20(c)(1) as the interest rate disclosed in the last notice, as well as all other interest rates applied to the transaction in the period since the last notice, or, if there had been no prior adjustment notice, the interest rate applicable at consummation and all other interest rates applied to the transaction in the period since consummation.

In all rounds of testing, consumers were presented with model forms with tables depicting a scenario in which the interest rate and payment would increase as a result of the adjustment. All participants in all rounds of testing understood that their interest rate and payment were going to increase and when these changes would occur.[66]

Current ARM notices are not required to show the allocation of payments among principal, interest, and escrow accounts for any ARM. The Bureau proposes including this information in the table for interest-only and negatively-amortizing ARMs. The Bureau believes this information would help consumers better understand the risk of these products by demonstrating that their payments would not reduce the principal. The Bureau also believes providing the payment allocation would help consumers understand the effect of the interest rate adjustment, especially in the case of a change in the ARM's features coinciding with the interest rate adjustment, such as the expiration of an interest-only or payment-option feature. Since payment allocation may change over time, the proposed rule would require disclosure of the expected payment allocation for the first payment period during which the adjusted interest rate would apply.

The allocation of payment disclosure was tested in the third round of testing. The rate adjustment notice tested showed the following scenario: the first adjustment of a 3/1 hybrid ARM -- an ARM with a fixed interest rate for three years followed by annual interest rate adjustments -- with interest-only payments for the first three years. On the date of the

[66] *Id.*

adjustment, the interest-only feature would expire and the ARM would become amortizing. Only about half of participants understood that their payments were changing from interest-only to amortizing. Participants generally understood the concept of allocation of payments but were confused by the table in the notice that broke out principal and interest for the current payment, but combined the two for the new amount. As a result, this table was revised so that separate amounts for principal and interest were shown for all payments. [67]

The Bureau recognizes that certain Dodd-Frank Act amendments to TILA will restrict origination of non-amortizing and negatively-amortizing loans. For example, TILA section 129C and the 2011 ATR (Ability to Repay) Proposal which would implement that provision, generally require creditors to determine that a consumer can repay a mortgage loan and include a requirement that these determinations assume a fully-amortizing loan. Thus, this law and regulation, when finalized, will restrict the origination of risky mortgages such as interest-only and negatively-amortizing ARMs.

Other Dodd-Frank amendments to TILA, such as the proposed periodic statement provisions discussed below, will provide payment allocation information to consumers for each billing cycle. Thus, consumers who currently have interest-only or negatively-amortizing loans or may obtain such loans in the future will receive information about the interest-only or negatively-amortizing features of their loans through the payment allocation information in the periodic statement. Also, as noted above, consumer testing showed that participants were confused by the allocation table. Since the Bureau was not able to test a revised version of the model form to see if it rectified the confusion caused by the allocation table or if the concepts of interest-only and negatively-amortizing ARMs themselves are the source of the confusion, the Bureau is uncertain of the value of disclosing this information to consumers in the ARM interest rate adjustment notice. In view of these changes to the law and the outcome of consumer testing, the Bureau solicits comments on whether to include allocation information for interest-only and negatively-amortizing ARMs in the table proposed above.

20(c)(2)(iii) Explanation of How the Interest Rate is Determined

Proposed § 1026.20(c)(2)(iii) would require the ARM disclosures to explain how the interest rate is determined. Consumer testing revealed that consumers generally have difficulty understanding the relationship of the index, margin, and interest rate.[68] Therefore, the Bureau is proposing a relatively brief and simple explanation that the new interest rate is calculated by taking the published index rate and adding a certain number of percentage points, called the "margin." Proposed § 1026.20(c)(2)(iii) would also require disclosure of the specific amount of the margin.

The proposed explanation of how the consumer's new interest rate is determined, such as adjustment of the index by the addition of a margin, mirrors the pre-consummation disclosure required around the time of application by current § 1026.19(b)(2)(iii) and TILA section 128A requirements for initial interest rate disclosures. It also parallels the pre-consummation disclosure of the index and margin proposed in the 2012 TILA-RESPA Proposal. Proposed

[67] *Id.* at vii- viii. This revision to the allocation disclosure, which is identical in the proposed § 1026.20(c) and (d) notices, was made after the third round of testing of the § 1026.20(d) notice, and therefore was not tested with consumers.
[68] *Id.* at viii.

§ 1026.20(c) also would require disclosure of the name and published source of the index or formula, as required in other disclosures by § 1026.19(b)(2)(ii) and TILA section 128A.

The proposed rule would replace the current § 1026.20(c)(2) required disclosure of the index values upon which the "current" and "prior" interest rates are based. The Bureau believes that providing consumers with index values is less valuable than providing them with their actual interest rates. Current comment 20(c)(2)-1, which addresses the requirement to disclose current and prior interest rate, would also be deleted.

Consumer testing indicated that the explanation helped consumers better understand the relationship between interest rate, index, and margin. It also helped dispel the notion held by many consumers in the initial rounds of testing that lenders subjectively determined their new interest rate at each adjustment.[69] The Bureau believes that its proposed rule and forms strike an appropriate balance between providing consumers with key information necessary to understand the basic interest rate adjustment of their adjustable-rate mortgages without overloading consumers with complex and confusing technical information.

20(c)(2)(iv) Rate Limits and Unapplied Carryover Interest

Proposed § 1026.20(c)(2)(iv) would require the disclosure of any limits on the interest rate or payment increases at each adjustment and over the life of the loan. It also would require disclosure of the extent to which the creditor has foregone any increase in the interest rate due to a limit, called unapplied carryover interest. Disclosure of rate limits is not required by the current rule. The Bureau believes that knowing the limitations of their ARM rates and payments would help consumers understand the consequences of interest rate adjustments and weigh the relative benefits of pursuing alternatives. For example, if an adjustment causes a significant increase in the consumer's payment, knowing how much more the interest rate or payment could increase could help inform a consumer's decision on whether or not to seek alternative financing.

Both proposed § 1026.20(c)(2)(iv) and current § 1026.20(c)(3) require disclosure of any foregone interest rate increase. Unlike the current rule, the proposed rule would require an explanation in the ARM payment change notice that the additional interest was not applied due to a rate limit and provide the earliest date such foregone interest may be applied.

Proposed comment 20(c)(2)(iv)-1 regarding unapplied interest closely parallels, and would replace, current comment 20(c)(3)-1. The proposed comment explains that disclosure of foregone interest would apply only to transactions permitting interest rate carryover. It further explains that the amount of the interest increase foregone is the amount that, subject to rate caps, can be added to future interest rate adjustments to increase, or offset decreases in, the rate determined according to the index or formula.

Consumers had difficulty understanding the concept of interest rate carryover when it was introduced during the third round of testing. This difficulty may have been due to the simultaneous introduction of other complex notions, such as interest-only or negatively-amortizing features and the allocation of interest, principal, and escrow payments for such loans. In response, the Bureau has simplified the explanation of carryover interest.[70]

[69] *Id.*
[70] *Id.* at viii-ix.

The Bureau recognizes that the disclosure of rate limits and unapplied carryover interest provide information that may help consumers better understand their ARMs. However, the Bureau is considering whether the help this information may provide outweighs its distraction from other more key information. Also, as explained above, consumers had difficulty understanding the concept of carryover interest and the Bureau does not want this difficulty to diminish the effectiveness of the proposed § 1026.20(c) disclosures. The Bureau solicits comment on whether to include rate limits and unapplied carryover interest in the proposed § 1026.20(c) disclosures.

20(c)(2)(v) Explanation of How the New Payment is Determined

Proposed § 1026.20(c)(2)(v) would require ARM disclosures to explain how the new payment is determined, including (A) the index or formula, (B) any adjustment to the index or formula, such as by addition of the margin or application of previously foregone interest, (C) the loan balance, and (D) the length of the remaining loan term. This explanation is consistent with the disclosures provided at the time of application pursuant to § 1026.19(b)(2)(iii). It is also consistent with the TILA section 128A requirement to disclose the assumptions upon which the new payment is based, which the Bureau proposes to implement in proposed § 1026.20(d), and thus promotes consistency among Regulation Z ARM disclosures.

The current rule, as explained in comment 20(c)(4)-1, which the proposed rule would delete, requires disclosure of the contractual effects of the adjustment. This includes the payment due after the adjustment is made and whether the payment has been adjusted. The proposed rule would require disclosure of this information as well as the name of the index and any specific adjustment to the index, such as the addition of a margin or an adjustment due to carryover interest. Proposed comment 20(c)(2)(v)(B)-1 explains that a disclosure regarding the application of previously foregone interest is required only for transactions permitting interest rate carryover. The proposed comment further explains that foregone interest is any percentage added or carried over to the interest rate because a rate cap prevented the increase at an earlier adjustment. As discussed above, the Bureau found that this explanation helped consumers better understand how the index or formula and margin determine their new payment and dispelled the notion held by many consumers in the initial rounds of testing that the lender subjectively determined their new interest rate, and thus the new payment, at each adjustment.

The proposal would require disclosure of both the loan balance and the remaining loan term expected on the date of the interest rate adjustment. The current rule requires disclosure of the loan balance but not the remaining loan term. The date on which the balance is taken differs slightly in proposed § 1026.20(c) from the current rule. Current comment 20(c)(4)-1 explains that the balance disclosed is the one that serves as the basis for calculating the new adjusted payment while the Bureau proposes disclosure of a more current balance, *i.e.*, the one expected on the date of the adjustment. Both the proposed rule and the current rule, as explained in current comment 20(c)(4)-1, provide for disclosure of any change in the term or maturity of the loan caused by the adjustment.

Disclosure of the four key assumptions upon which the new payment is based provides a succinct overview of how the interest rate adjustment works. It also demonstrates that factors other than the index can increase consumers' interest rates and payments. Disclosures of these factors would provide consumers with a snapshot of the current status of their adjustable-rate mortgages and with basic information to help them make decisions about keeping their current loan or shopping for alternatives.

Current comment 20(c)(4)-1 requires disclosure of certain information related to loans that are not fully amortizing. Disclosure of similar information is proposed in § 1026.20(c)(2)(vi), discussed below.

20(c)(2)(vi) Interest-Only and Negative-Amortization Statement and Payment

Proposed § 1026.20(c)(2)(vi) would require § 1026.20(c) notices to include a statement regarding the allocation of payments to principal and interest for interest-only or negatively-amortizing loans. If negative amortization occurs as a result of the interest rate adjustment, the proposed rule would require disclosure of the payment necessary to fully amortize such loans at the new interest rate over the remainder of the loan term. As explained in proposed comment 20(c)(2)(vi)-1, for interest-only loans, the statement would inform the consumer that the new payment covers all of the interest but none of the principal owed and, therefore, will not reduce the loan balance. For negatively-amortizing ARMs, the statement would inform the consumer that the new payment covers only part of the interest and none of the principal, and therefore the unpaid interest will add to the balance or increase the term of the loan. The current rule, clarified by current comment 20(c)(5)-1, requires disclosure of the payment necessary to fully amortize loans that become negatively-amortizing as a result of the adjustment but does not require the statement regarding amortization. Proposed § 1026.20(c)(2)(vi) and proposed comments 20(c)(2)(vi)-1 and 20(c)(2)(vi)-2 would replace the current rule and current comment 20(c)(5)-1.

Both current § 1026.20(c) and the Board's 2009 Closed-End Proposal to revise § 1026.20(c) include, for ARMs that become negatively amortizing as a result of the interest rate adjustment, disclosure of the payment necessary to fully amortize those loans at the new interest rate over the remainder of the loan term. However, the Bureau believes there are countervailing considerations regarding whether to include this information in proposed § 1026.20(c).

The Bureau recognizes that certain Dodd-Frank Act amendments to TILA will restrict origination of non-amortizing and negatively-amortizing loans. For example, TILA section 129C and the 2011 ATR Proposal that would implement that provision, generally require creditors to determine that a consumer can repay a mortgage loan and include a requirement that these determinations assume a fully-amortizing loan. Thus, this law and regulation, when finalized, will restrict the origination of risky mortgages such as interest-only and negatively-amortizing ARMs.

Other Dodd-Frank amendments to TILA, such as the periodic statement proposed by § 1026.41, will include information about non-amortizing and negatively-amortizing loans in each billing cycle, such as an allocation of payments. Thus, consumers who currently have interest-only and negatively-amortizing ARMs or may obtain such loans in the future will receive certain information about the interest-only or negatively-amortizing features of their loans in another disclosure, although this will not include the payment required to fully amortize negatively-amortizing loans. Disclosure of the payment necessary to fully amortize negatively-amortizing loans was not consumer tested but testing of the table showing the payment allocation of interest-only and negatively-amortizing ARMs indicated that consumers were confused by the concept of amortization. Thus, the Bureau is weighing the value of disclosing specific information regarding amortization, such as the payment needed to fully amortize negatively-amortizing ARMs. In view of these changes to the law and the outcome of consumer testing, the Bureau solicits comments on whether to include the payment required to amortize ARMs that became negatively amortizing as a result of an interest rate adjustment.

20(c)(2)(vii) Prepayment Penalty

Proposed § 1026.20(c)(2)(vii) would require disclosure of the circumstances under which any prepayment penalty may be imposed, such as selling or refinancing the principal residence, the time period during which such penalty would apply, and the maximum dollar amount of the penalty. The current rule does not have this requirement. The proposed rule cross-references the definition of prepayment penalty in subpart E, § 1026.41(d)(7)(iv), in the proposed rule for periodic statements.

Interest rate adjustments may cause payment shock or require consumers to pay their mortgage at a rate they may no longer be able to afford, prompting them to consider alternatives such as refinancing. In order to fully understand the implications of such actions, the Bureau believes that consumers should know whether prepayment penalties may apply. Such information should include the maximum penalty in dollars that may apply and the time period during which the penalty may be imposed. The dollar amount of the penalty, as opposed to a percentage, is more meaningful to consumers.

The Bureau also proposes disclosure of any prepayment penalty in § 1026.20(d) ARM rate adjustment notices and in the periodic statements proposed by § 1026.41. Consumer testing of the periodic statement included a scenario in which a prepayment penalty applied. Most participants understood that a prepayment penalty applied if they paid off the balance of their loan early, but some participants were unclear whether it applied to the sale of the home, refinancing, or other alternative actions consumers could pursue in lieu of maintaining their adjustable-rate mortgages.[71] For this reason, the Bureau proposes to clarify the circumstances under which a prepayment penalty would apply. The proposed forms would alert consumers that a prepayment penalty may apply if they pay off their loan, refinance, or sell their home before the stated date.

The Bureau recognizes that Dodd-Frank Act amendments to TILA, such as 129C and the 2011 ATR Proposal that would implement that provision, would significantly restrict a lender's ability to impose prepayment penalties. Other Dodd-Frank amendments to TILA, such as the proposed periodic statement, would provide consumers with information about their prepayment penalties for each billing cycle. Thus, consumers who currently have ARMs with prepayment penalty provisions or may obtain such loans in the future would generally receive information about them at frequent intervals in another disclosure. In view of these changes to the law, the Bureau solicits comments on whether to include information regarding prepayment penalties in proposed § 1026.20(c).

20(c)(3) Format of Disclosures

As discussed above, the Bureau proposes to make § 1026.20(c) subject to certain of the § 1026.17(a)(1) form requirement to which § 1026.20(c) disclosures are currently not subject. These requirements include grouping the disclosures together, segregating them from everything else, and prohibiting inclusion of any information not directly related to the § 1026.20(c)

[71] *Id.* at vi.

disclosures.[72] As discussed above in connection with Section 17(a)(1), this revises the current rule but the Bureau believes the revision is necessary to effectively highlight information for consumers about changes to their ARM interest rates and payments.

20(c)(3)(i) All Disclosures in Tabular Form

Proposed § 1026.20(c)(3)(i) would require that the ARM adjustment disclosures be provided in the form of a table and in the same order as, and with headings and format substantially similar to, Forms H-4(D)(1) and (2) in Appendix H to subpart C for interest rate adjustments resulting in a corresponding payment change.

The proposed ARM adjustment notice contains complex concepts challenging for consumers to understand. For example, consumer testing revealed that participants generally had difficulty understanding the relationship among index, margin, and interest rate.[73] They also had difficulty with the concepts of amortization and interest rate carryover.[74] As a starting point, the Bureau looked at the model forms developed by the Board for its 2009 Closed-End Proposal to amend §1026.20(c). The Bureau then conducted its own consumer testing.

The Bureau's testing showed that consumers can more readily understand these concepts when the information is presented to them in a simple manner and in the groupings contained in the model forms. The Bureau also observed that consumers more readily understood the concepts when they were presented in a logical order, with one concept presented as a foundation to understanding other concepts. For example, the form begins by informing consumers of the purpose of the notice: that their interest rate is going to adjust, when it will adjust, and that the adjustment will change their mortgage payment. This introduction is immediately followed by a table visually showing consumers' current and new interest rates. In another example, the proposed notice informs consumers about their index rate and margin before explaining how the new payment is calculated based on those factors, as well as other factors such as the loan balance and remaining loan term.

Based on consumer testing, the Bureau believes that consumer understanding is enhanced by presenting the information in a simple manner, grouped together by concept, and in a specific order that allows consumers the opportunity to build upon knowledge gained. For these reasons, the Bureau proposes that creditors, assignees, or servicers disclose the information required by proposed § 1026.20(c) with headings, content, and format substantially similar to Forms H-4(D)(1) and (2) in Appendix H to this part.

Over the course of consumer testing, participant comprehension improved with each successive iteration of the model form. As a result, the Bureau believes that displaying the information in tabular form focuses consumer attention and lends to greater understanding. Similarly, the Bureau found that the particular content and order of the information, as well as the specific headings and format used, presented the information in a way that consumers both could understand and from which they could benefit.

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[72] Other § 1026.17(a)(1) form requirements that currently apply to § 1026.20(c) would continue to apply, such as the option of providing the disclosures to consumers in electronic form, subject to compliance with consumer consent and other applicable provisions of the E-Sign Act.
[73] Macro Report, *supra* note 38, at viii.
[74] *Id.* at viii-ix.

20(c)(3)(ii) Format of Interest Rate and Payment Table

Proposed § 1026.20(c)(3)(ii) would require tabular format for ARM payment change notices of: the current and new interest rates, the current and new payments, and the date the first new payment is due. For interest-only and negatively-amortizing ARMs, the table would also include the allocation of payments. This table would be located within the table proposed by § 1026.20(c)(3)(i). This table is substantially similar to the one tested by the Board for its 2009 Closed-End Proposal to revise § 1026.20(c). The proposal would require the table to follow the same order as, and have headings, content, and format substantially similar to, Forms H-4(D)(1) and (2) in Appendix H of subpart C.

Disclosing the current interest rate and payment in the same table allows consumers to readily compare those rates with the adjusted rate and new payment. Consumer testing revealed that nearly all participants were readily able to identify the table and understand the content.[75] The new interest rate and payment and date the first new payment is due is key information the consumer must know in order to commence payment at the new rate. For these reasons, the Bureau proposes locating this information prominently in the disclosure.

20(d) Initial Rate Adjustments

Elimination of current § 1026.20(d). Current § 1026.20(d) permits creditors to substitute information provided in accordance with variable-rate subsequent disclosure regulations of other Federal agencies for the disclosures required by § 1026.20(c). In the 2009 Closed-End Proposal, the Board proposed amending the regulation that is now § 1026.20, including deleting the provision that is current § 1026.20(d). The Board stated that, as of August 2009, there were "[n]o comprehensive disclosure requirements for variable-rate mortgage transactions . . . in effect under the regulations of the other Federal financial institution supervisory agencies."[76] The Board explained that when it originally adopted the provision in 1987, as footnote 45c of § 226.20(c) of Regulation Z,[77] the regulations of other financial institution supervisory agencies -- namely the OCC, the Federal Home Loan Bank Board (the FHLBB), and HUD -- contained subsequent disclosure requirements for ARMs.[78]

The Bureau proposes deleting the current content of § 1026.20(d) because it is not aware of any other Federal financial institution supervisory agency rules requiring comprehensive disclosure requirements for ARMs. The Bureau solicits comment on whether there is any reason to retain this provision. The Bureau solicits comments, for example, on whether this proposed regulatory change would have implications for rights under the Alternative Mortgage Transaction Parity Act (AMTPA). For the reasons discussed above with respect to proposed § 1026.20(c), the Bureau proposes this deletion pursuant to its authority under TILA sections 105(a) and 128(f)(1)(H) and DFA section 1405(b).

New initial ARM interest rate adjustment disclosures. In the section that would be left vacant by the proposed deletion of § 1026.20(d), the Bureau proposes to implement the initial

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[75] *Id.* at vii.

[76] 74 FR 43232, 43272 (Aug. 26, 2009).

[77] Regulation Z was previously implemented by the Board at 12 CFR 226. In light of the general transfer of the Board's rulemaking authority for TILA to the Bureau, the Bureau adopted an interim final rule recodifying the Board's Regulation Z at 12 CRF 1026.

[78] 74 FR 43232, 43273 (*citing* 52 FR 48665, 48671 (Dec. 24, 1987)).

ARM adjustment notice mandated by TILA section 128A. Proposed § 1026.20(d) would require disclosure to consumers with certain adjustable-rate mortgages, approximately six months prior to the initial interest rate adjustment, of key information about the upcoming adjustment, including the new rate and payment and options for pursuing alternatives to their adjustable-rate mortgage. This initial ARM adjustment notice would harmonize with the ARM payment change notice that would be required under the proposed revisions to § 1026.20(c). The Bureau believes that promoting consistency between the ARM disclosure provisions of proposed § 1026.20(c) and (d) would reduce compliance burdens on industry and minimize consumer confusion.

Form of delivery. As required under TILA section 128A(b), proposed § 1026.20(d) would require that the initial ARM interest rate adjustment notices be provided to consumers in writing, separate and distinct from all other correspondence. Proposed comment 20(d)-2 explains that to satisfy this requirement, the notices must be mailed or delivered separately from any other material. For example, in the case of mailing the disclosure, there should be no material in the envelope other than the initial interest rate adjustment notice. In the case of emailing the disclosure, the only attachment should be the initial interest rate adjustment notice. This requirement contrasts with proposed § 1026.20(c), which would be subject to the less stringent segregation requirements of § 1026.17(a)(1), as amended by the Bureau's proposal. The proposed comment further explains that the notices proposed by § 1026.20(d) may be provided to consumers in electronic form with consumer consent, pursuant to the requirements of § 1026.17(a)(1). The Bureau solicits comments on whether consumer protection would be compromised by providing § 1026.20(d) notices on a separate piece of paper but in the same envelope or as email correspondence with other messages from the creditor, assignee, or servicer.

Creditors, assignees, and servicers. Proposed § 1026.20(d) applies to creditors, assignees, and servicers. Proposed comment 20(d)-1 clarifies that a creditor, assignee, or servicer that no longer owns the mortgage loan or the mortgage servicing rights is not subject to the requirements of § 1026.20(c). This proposed language tracks, in part, the requirements of TILA section 128Athat creditors and servicers must provide the initial ARM interest rate adjustment notices, but adds assignees to the list of covered persons. The Bureau believes that holding creditors, but not assignees, liable under the regulation would result in inconsistent levels of consumer protection and an unlevel playing field for owners of mortgages.

It is a common practice for creditors to sell many or all of the loans they originate rather than hold them in portfolio. If the creditor were to sell the ARM, the consumer would have no recourse against the subsequent holder for violations of § 1026.20(d) if assignees were not made subject to § 1026.20(d). Shielding assignees from liability under the proposed rule would have particularly deleterious effects on consumers seeking relief against a servicer to whom an assignee sold the ARM's mortgage servicing rights, if that servicer had insufficient resources to satisfy a judgment the consumer may obtain for violations of § 1026.20(d). Consumers who happen to have ARMs sold by the original creditor to a subsequent holder would have less protection under the regulation than consumers with ARMs that are retained in portfolio by the creditor originating the loan. It also would create an unfair advantage for assignees. The Bureau believes that the protections afforded under proposed § 1026.20(d) should not be determined by the happenstance of loan ownership or favor one sector of the mortgage market over another. For these reasons, the Bureau proposes to make assignees, along with creditors and servicers, subject to the requirements § 1026.20(d).

Proposed comment 20(d)-1 explains that any provision of subpart C that applies to the disclosures required by § 1026.20(d) also applies to creditors, assignees, and servicers. This is the case even where the other provisions of subpart C refer only to creditors. For the reasons discussed above, the Bureau proposes that the requirements of other regulations that apply to the § 1026.20(d) initial ARM interest rate adjustment notices apply to assignees as well as to creditors and servicers.

The extension of the requirement to assignees is authorized under TILA section 105(a) because, for the reasons discussed above, it is necessary and proper to effectuate the purposes of TILA, including to assure a meaningful disclosure of credit terms and protect the consumer against unfair credit billing practices, and to prevent circumvention or evasion of TILA. The Bureau also proposes to use its authority under DFA section 1405(b) to extend the applicability of the initial ARM adjustment notices under TILA section 128A to assignees. As discussed above, this extension would serve the interest of consumers and the public interest. Application of proposed § 1026.20(d) to assignees is consistent with current § 1026.20(c) commentary applying that disclosure requirement to subsequent holders. Application of proposed § 1026.20(d) to creditors, assignees, and servicers also promotes consistency with proposed § 1026.20(c) and the periodic statement proposed by § 1026.41, which also apply to creditors, assignees, and servicers.

Timing. Proposed § 1026.20(d) generally follows the statutory requirement in TILA section 128A that the initial interest rate adjustment notice must be provided to consumers during the one-month period that ends six months before the date on which the interest rate in effect during the introductory period ends. Thus, the disclosure must be provided six to seven months before the initial interest rate adjustment. The § 1026.20(d) disclosures are designed to avoid payment shock so as to put consumers on notice of upcoming changes to their adjustable-rate mortgages that may result in higher payments. The six to seven month advance notice allows sufficient time for consumers to consider their alternatives if the notice discloses an increase in payment that they cannot afford. One alternative consumers might consider is refinancing their home. In the current market, "it now takes the nation's biggest mortgage lenders an average of more than 70 days to complete a refinance . . . ."[79]

In the interest of consistency within Regulation Z, proposed § 1026.20(d) ties its timing requirement to the date the first payment at a new level is due rather than the date of the interest rate adjustment. This is consistent with the time frame for both current and proposed § 1026.20(c). Since interest generally is paid in arrears, for most ARMs, this adds another approximately 30 days to the time frame for delivery of the disclosures. Thus, the notices proposed by § 1026.20(d) must be provided to consumers seven to eight months in advance of payment at the adjusted rate. Measured in days, the initial interest rate adjustment disclosures are due at least 210, but not more than 240, days before the first payment at the adjusted level is due. By tying the timing of the disclosure to the date payment at a new level is due and calculating it in days rather than months, proposed § 1026.20(d) is more precise, since months can vary in length, and maintains consistency with the timing requirements of proposed § 1026.20(c).

[79] Timiraos & Simon, *supra* note 52.

Pursuant to TILA section 128A, for ARMs adjusting for the first time within six months after consummation, the proposed § 1026.20(d) initial interest rate adjustment notices must be provided at consummation. The proposed rule states that when this occurs, the disclosure must be provided 210 days before the first date payment at a new level is due. The proposed rule ties the timing of this requirement to days rather than months, thereby ensuring both internal consistency and consistency with § 1026.20(c).

Proposed comment 20(d)-2 explains that the timing requirements exclude any grace period. It also explains that the date the first payment at the adjusted level is due is the same as the due date of the first payment calculated using the adjusted interest rate.

SBREFA. The small entity representatives (SERs) that advised the SBREFA panel on the mortgage servicing rules under consideration by the Bureau expressed doubt as to the value of the § 1026.20(d) notices because providing the notices so many months in advance of the interest rate adjustment would require disclosure of an estimated, rather than the actual, interest rate and payment due.[80] Several SERS expressed concern that the estimates would confuse consumers. They also noted that, in addition to the requirement to provide initial interest rate adjustment notices under § 1026.20(d), servicers would remain obliged to also provide a later notice in the case of a payment change, pursuant to § 1026.20(c), for the initial rate adjustments in order to apprise consumers of the actual amount of their interest rate and payment resulting from the adjustment. They expressed concerns about the one-time development costs and on-going costs associated with providing both the initial ARM adjustment notices and the recurring notices under § 1026.20(c).[81]

Consistent with this recommendation, after conclusion of the SBREFA process, the Bureau conducted further policy analysis of a possible exemption for small creditors, assignees, and servicers. After additional consideration, however, the Bureau decided to propose that notices under both § 1026.20(c) and § 1026.20(d) be provided. The Bureau believes that the two notices serve related but distinct purposes, such that eliminating the § 1026.20(c) notice could harm consumers. In particular, the § 1026.20(d) notice is designed to provide consumers with very early warning that their rates are about to change, so that consumers can begin exploring other options. If the consumer chooses not to do so or has not completed that process, a notice closer to the adjustment date that reflects the actual rather than estimated change in payment is still valuable to the consumer as both a second warning and budgeting tool. While the ARM interest rate adjustment information proposed for the first payment change notice required by proposed § 1026.20(c) could be provided in the periodic statement that would be provided to consumers under proposed § 1026.41, discussed below, rather than as a standalone notice under § 1026.20(c), the Bureau notes that that might require greater programming complexity in connection with the periodic statements. In addition, the Bureau is proposing to exempt certain small servicers from the periodic statement requirement.

The Bureau also believes that the amount of burden reduction for servicers from an exemption from providing a § 1026.20(c) notice in connection with an initial interest rate adjustment would be extremely minimal, given that servicers would have to maintain systems to generate § 1026.20(c) notices for each subsequent interest rate adjustment resulting in a

[80] *See* SBREFA Final Report, *supra* note 22, at 20-21, 29-30.
[81] *Id*.

corresponding payment change. Thus, excepting small servicers from providing the first § 1026.20(c) notice would not provide a significant reduction in burden.

The Bureau also considered whether to except small servicers, creditors, and assignees from the initial ARM interest rate notice required by § 1026.20(d). The SERs expressed concern that consumers would be confused by receiving estimates, rather than their actual new interest rate and payment, in the § 1026.20(d) notice.[82] However, the Bureau believes the best approach to address this concern is to clarify the contents of the notice, rather than eliminate it entirely. Congress has made a specific policy judgment that an early notice has value to consumers. Creating an exemption for small creditors, assignees, and servicers would deprive certain consumers of the benefits that Congress intended, specifically advance notice seven to eight months before payment at a new level is due after the initial interest rate adjustment to allow consumers time to weigh the potential impacts of a rate change and to explore alternative actions. An exception would also deprive certain consumers of the information provided in the § 1026.20(d) notice about alternatives and how to contact their State housing finance authority and access a list of government-certified counseling agencies and programs.

On balance, the Bureau does not believe that the § 1026.20(d) notice imposes a significant burden on small entities because it is a one-time notice. Moreover, the notice is designed to be consistent with the § 1026.20(c) notice in order to, among other things, reduce the burden on industry. For these reasons, the Bureau proposes generally to require all creditors, assignees, and servicers to provide the ARM interest rate adjustment notices required by proposed § 1026.20(c) and (d). However, the Bureau seeks comment on the issues raised by the two sets of disclosures, particularly whether the burden imposed on small entities by the requirements of § 1026.20(d) outweighs the consumer protection benefits afforded by the early notice of the initial ARM interest rate adjustment.

The Bureau also solicits comment on whether small servicers (or creditors, assignees, and servicers in general) that provide a periodic statement to a consumer with an ARM should be permitted or required to provide the information required by § 1026.20(c), for an initial interest rate adjustment for which a notice under § 1026.20(d) is required, in a periodic statement provided to consumers 60 to 120 days before payment at a new level is due. The Bureau further solicits comment on whether to permit or require all § 1026.20(c) notices required by the proposed rule to be incorporated into periodic statements in lieu of providing a separate notice.

Conversions. Proposed comment 20(d)-3 explains that in the case of an open-end account converting to a closed-end adjustable-rate mortgage, § 1026.20(d) disclosures are not required until the implementation of the initial interest rate adjustment post-conversion. Under the proposed rule, the conversion is analogous to consummation. Thus, like other ARMs subject to the requirements of proposed § 1026.20(d), disclosures for these converted ARMs would not be required until the first interest rate adjustment following the conversion. This proposal is consistent with the § 1026.20(c) proposal for open-end accounts converting to closed-end adjustable-rate mortgages.

20(d)(1) Coverage of the Initial Rate Adjustment Disclosures

20(d)(1)(i) In General

[82] *Id.* at 21.

Proposed § 1026.20(d)(1)(i) defines an adjustable-rate mortgage or ARM as a closed-end consumer credit transaction secured by the consumer's principal dwelling in which the annual percentage rate may increase after consummation. The proposed rule uses the wording from the definitions of "adjustable-rate" and "variable-rate" mortgage in subpart C of Regulation Z. It does this to promote consistency within the regulation. Proposed comment 20(d)(1)(i)-1 explains that the definition of ARM means variable-rate mortgage as that term is used elsewhere in subpart C of Regulation Z, except as provided in proposed comment 20(d)(1)(ii)-2.

Applicability to closed-end transactions. The Bureau believes that TILA section 128A and the implementing disclosures in proposed 1026.20(d) primarily benefit consumers with closed-end adjustable-rate mortgages. In contrast, open-end credit transactions secured by a consumer's dwelling (home equity plans) with adjustable-rate features are subject to distinct disclosure requirements under TILA and subpart B of Regulation Z that substitute for the proposed § 1026.20(c) and (d) disclosures. Therefore, as discussed below, the Bureau proposes to use its authority under TILA section 105(a) and (f) to exempt adjustable-rate home equity plans from the requirements of proposed § 1026.20(d).

Section 127A of TILA and § 1026.40(b) and (d) of Regulation Z require the disclosure of specific information about home equity plans at the time an application is provided to the consumer. These disclosures include specific information about variable or adjustable-rate plans, including, among other things, the fact that the plan has a variable or adjustable-rate feature, the index used in making adjustments and a source of information about the index, an explanation of how the index is adjusted such as by the addition of a margin, and information about frequency of and limitations to changes to the applicable rate, payment amount, and index. *See* § 1026.40(d)(12). The required account opening disclosures for home equity plans also must include information about any variable or adjustable-rate feature, including the circumstances under which rates may increase, limitations on the increase, and the effect of any increase. *See* § 1026.6(a)(1)(ii) and (3)(vii).

Thus, Regulation Z already contains a comprehensive scheme for disclosing to consumers the variable or adjustable-rate features of home equity plans. The Bureau believes that requiring servicers to provide information about the index and an explanation of how the interest rate and payment would be determined, as required by TILA section 128A and proposed by § 1026.20(d), in connection with home equity plans would be inconsistent with, and largely duplicative of, the current disclosure regime and would be confusing and unhelpful for consumers. Moreover, unlike closed-end adjustable-rate mortgages, consumers with home equity plans generally may draw from the adjustable-rate feature on the account at any time. Thus, providing the good faith estimate of the amount of the monthly payment that would apply after the interest rate adjustment, as required by TILA section 128A and proposed by § 1026.20(d), would not be useful because the estimate would be based on the outstanding loan balance at the time the notice is given, which would change after the notice is given anytime the consumer withdraws funds. Finally, the alerts to consumers required by TILA section 128A and proposed by §1026.20(d) would not provide a benefit to consumers with home equity plans with adjustable-rate features. Generally, introductory periods for adjustable-rate features on home equity plans tend to last less than six months. The Bureau believes it is unlikely consumers would consider pursuing alternatives so close in time to opening their home equity plans.

Two other factors also support the Bureau's use of the TILA section 105(a) exemption authority to exclude home equity plans from the requirements of proposed § 1026.20(d). First, use of the term "consummation" in TILA section 128A supports the application of proposed §1026.20(d) only to closed-end transactions. Regulation Z generally requires disclosures for closed-end credit transactions to be provided "before consummation of the transaction." By contrast, Regulation Z generally requires account opening disclosures for open-end credit transactions to be provided "before the first transaction is made under the plan." *See* § 1026.17(b) and § 1026.5(b)(1)(i). Because Regulation Z uses the term "consummation" in connection with closed-end credit transactions, use of the word "consummation" in DFA section 1418 supports the Bureau's proposed exemption for open-end home equity plans from the requirements of §1026.20(d). Second, DFA section 1418 is codified in TILA section 128A. The adjacent and similarly numbered provision, TILA section 128, is entitled and applies only to "Consumer Credit not under Open End Credit Plans." Congress's placement of the new ARM disclosure requirement in a segment of TILA that applies only to closed-end credit transactions further supports the Bureau's decision to exempt open-end credit transactions, in this case variable or adjustable-rate home equity plans, from the requirements of that section.

For the reasons discussed above, exempting home equity plans from the requirements of §1026.20(d) is necessary and proper under TILA section 105(a) to further the consumer protection purposes of TILA and facilitate compliance. As discussed above, the Bureau believes that the information contained in the notice proposed by § 1026.20(d) would not be meaningful to consumers with home equity plans that have adjustable-rate features and could lead to information overload and confusion for those consumers. The Bureau further proposes the exemption for open-end transactions pursuant to its authority under TILA section 105(f). As discussed above, because open-end transactions are subject to their own regulatory scheme, are not structured in such a way as to garner benefit from the disclosures proposed by §1026.20(d), and the placement of 128A in TILA indicates congressional intent to limit its coverage to closed-end transactions, the Bureau believes, in light of the factors in TILA section 105(f)(2), that requiring the proposed § 1026.20(d) notice for open-end accounts that have adjustable-rate features would not provide a meaningful benefit to consumers. Specifically, the Bureau considers that the exemption is proper irrespective of the amount of the loan or the status of the borrower (including related financial arrangements, financial sophistication, and the importance to the borrower of the loan). The Bureau further notes, in light of TILA section 105(f)(2)(D), that the requirements in § 1026.20(d) would only apply to loans secured by the consumer's principal dwelling.

Savings Clause. Regarding other categories of loans to which proposed § 1026.20(d) would apply, the statute's provisions apply to hybrid ARMs, which it defines as "consumer credit transaction[s] secured by the consumer's principal residence with a fixed interest rate for an introductory period that adjusts or resets to a variable interest rate after such period."[83] The statute, however, has a "savings clause," that allows the Bureau to require the initial interest rate adjustment notice for loans that are not hybrid ARMs. The Bureau proposes to use this authority generally to extend the disclosure requirements of proposed § 1026.20(d) to ARMs that are not hybrid. The Bureau believes this approach is necessary because both hybrid ARMs and those

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[83] TILA section 128A. For example, a 3/1 hybrid ARM has a three-year introductory period with a fixed interest rate, after which the interest rate adjusts annually. ARMs that are not hybrid, on the other hand, have no period with a fixed rate of interest. Such ARMs start out with a rate that adjusts at set intervals, such as 3/3 (adjusts every three years), 5/5 (adjusts every five years), etc.

that are not hybrid may subject consumers to the same payment shock that the advance notice of the first interest rate adjustment is designed to address. For example, both 3/1 hybrid ARMs, where the initial interest rate is fixed for three years and then adjusts every year after that, and 3/3 ARMs, where the initial interest rate adjusts after three years and then every three years after that, adjust for the first time after three years and present the same potential payment shock to consumers holding either mortgage. The same is true for 5/1 hybrid ARMs and 5/5 ARMs, 7/1 hybrid ARMs and 7/7 ARMs, 10/1 hybrid ARMs and 10/10 ARMs, etc. In sum, conventional ARMs and hybrid ARMs can have the same initial periods without an interest rate adjustment and thus, the same potential jump in their interest rates at the time of the first interest rate adjustment.

Proposed comment 20(d)(1)(i)-1 clarifies that the initial ARM adjustment notice are not limited to transactions financing the initial acquisition of the consumer's principal dwelling but also would apply to other closed-end ARM transactions secured by the consumer's principal dwelling, consistent with current comment 19(b)-1 and proposed § 1026.20(c).

20(d)(1)(ii) Exceptions

Proposed § 1026.20(d)(1)(ii) excepts construction loans with terms of one year or less from the disclosure requirements of § 1026.20(d). Proposed § 1026.20(c) includes the same exception. Proposed comment 20(d)(1)(ii)-1 applies the standards in comment 19(b)-1 for determining the term of a construction loan.

Construction loans generally have short terms of six months to one year and are subject to frequent interest rate adjustments, usually monthly or quarterly. The construction period usually involves several disbursements of funds at times and in amounts that are unknown at the beginning of that period. The consumer generally pays only accrued interest until construction is completed. The creditor, assignee, or servicer, in addition to disbursing payments in stages, closely monitors the progress of construction. Generally, at the completion of the construction, the construction loan is converted into permanent financing in which the loan amount is amortized just as in a standard mortgage transaction. *See* comment 17(c)(6)-2 for additional information on construction loans.

The frequent interest rate adjustments, multiple disbursements of funds, the short loan term, and on-going communication between the creditor, assignee, or servicer and consumer distinguish construction loans from other ARMs. These loans are meant to function as bridge financing until construction is completed and permanent financing can be put in place. Consumers with construction ARM loans are not at risk of payment shock like other ARM where interest rates change less frequently. Moreover, given the frequency of interest rate adjustments on construction loans, creditors, assignees, or servicers would have difficulty complying with the proposed requirement to provide the notice to consumers 210 to 240 days before the first payment at the adjusted level is due. For these reasons, providing notices under § 1026.20(d) for these loans would not provide a meaningful benefit to the consumer nor improve consumers' awareness and understanding of their construction loans with terms of less than one year.

Authority. Accordingly, the Bureau proposes to use its authority under TILA section 105(a) to except construction loans with terms of one year or less from the requirements of proposed § 1026.20(d). As explained above, the disclosure requirements of § 1026.20(d) would be confusing and difficult to comply with in the context of a short-term construction loan. Thus, exempting such loans is necessary and proper under TILA section 105(a) to further the consumer protection purposes of TILA and facilitate compliance. The Bureau further proposes the exemption for construction loans pursuant to its authority under TILA section 105(f). For the reasons discussed above, the Bureau believes, in light of the factors in TILA section 105(f)(2), that requiring the § 1026.20(d) notice for construction loans with terms of one year or less would not provide a meaningful benefit to consumers. Specifically, the Bureau considers that the exemption is proper irrespective of the amount of the loan or the status of the borrower (including related financial arrangements, financial sophistication, and the importance to the borrower of the loan). The Bureau further notes, in light of TILA section 105(f)(2)(D), that the requirements in § 1026.20(d) would only apply to loans secured by the consumer's principal dwelling.

The Bureau solicits comment on whether there are other ARMs with terms of less than one year, and whether such ARMs should be excepted from the requirements of § 1026.20(d). If the time period of the advance notice for consumers required by § 1026.20(d) is not appropriate for these short-term ARMs, the Bureau solicits comment on what period would be appropriate that would also provide consumers with sufficient notice of the estimated initial adjusted interest rate and any new payment.

Proposed comment 20(d)(1)(ii)-2 discusses other loans to which the proposed rule does not apply. Proposed comment 20(d)(1)(ii)-2 is consistent with proposed comment 20(c)(1)(ii)-3 with regard to the loans which are not subject to the proposed ARM disclosure rules. Certain Regulation Z provisions treat some of these loans as variable-rate transactions, even if they are structured as fixed-rate transactions. The proposed comment clarifies that, for purposes of proposed § 1026.20(d), the following loans, if fixed-rate transactions, are not ARMs and therefore are not subject to ARM notices pursuant to § 1026.20(d): shared-equity or shared-appreciation mortgages; price-level adjusted or other indexed mortgages that have a fixed rate of interest but provide for periodic adjustments to payments and the loan balance to reflect changes in an index measuring prices or inflation; graduated-payment mortgages or step-rate transactions; renewable balloon-payment instruments; and preferred-rate loans. The particular features of these types of loans may trigger interest rate or payment changes over the term of the loan or at the time the consumer pays off the final balance. However, these changes are based on factors other than a change in the value of an index or a formula. For example, whether or when the interest rate will adjust for the first time for a preferred-rate loan with a fixed interest rate is likely not knowable six to seven months in advance of the adjustment. This is because the loss of the preferred rate is based on factors other than a formula or change in the value of an index agreed to at consummation. Because the enumerated loans are not ARMs they are not covered by TILA section 128A or proposed § 1026.20(d) and require no disclosures under this rule.

20(d)(2) Content of Initial Rate Adjustment Disclosures

Statutorily-required content. TILA section 128A requires that the following content be included in the § 1026.20(d) initial rate adjustment notice: (1) any index or formula used in adjusting or resetting the interest rate and a source of information about the index or formula; (2) an explanation of how the new rate and payment would be determined, including how the index may be adjusted, such as by the addition of a margin; (3) a good faith estimate, based on accepted industry standards, of the amount of the resulting monthly payment after the adjustment or reset and the assumptions on which the estimate is based; (4) a list of alternatives that the consumers may pursue, including refinancing, renegotiation of loan terms, payment forbearance, and pre-foreclosure sales, and descriptions of actions the consumer must take to pursue these alternatives; (5) contact information for HUD- or State housing agency- approved housing counselors or programs reasonably available; and (6) contact information for the State housing finance authority for the State where the consumer resides.

The Bureau interprets the explanation of how the interest rate and payments will be determined set forth in (2) above to require disclosure of any adjustment to the index, for example, the amount of any margin and an explanation of what a margin is; the loan balance; the length of the remaining term of the loan; and any change in the term or maturity of the loan caused by the interest rate adjustment.

The Bureau interprets the good faith estimate, required under (3) above, to require disclosure, when available, of the exact amount of the new monthly payment after the interest rate adjustment. As discussed below, the Bureau believes that in most cases the lengthy advance notice required by proposed § 1026.20(d) will necessitate disclosure in the initial ARM interest rate adjustment notices of estimates of the new interest rate and payment, rather than exact amounts. The Bureau believes, however, that a good faith estimate would require disclosure of the exact amount of the new monthly payment, if known, rather than an estimate. The Bureau interprets the assumptions on which the good faith estimate is based to require disclosure, among other things, of the current interest rate and payment, as well as the amount of the new interest rate after the adjustment, if known, or an estimate if the exact amount of the new interest rate is not known. As with the new payment amount, the Bureau believes that generally only an estimate of the new interest rate will be available at the time the notice is provided, but interprets the statute to require disclosure of the exact amount of the new interest rate, if this amount is available. Even if this content were not contemplated under the statute, the Bureau believes it would be appropriate to use its adjustment authority to require disclosure of such information for the reasons discussed below.

Additional content. In addition to the content explicitly required under the statute, the Bureau proposes, as discussed in more detail below, to require the ARM initial interest rate notices to include the date of the disclosures; the telephone number of the creditor, assignee, or servicer; statements specifying that the consumer's interest rate is scheduled to adjust pursuant to the terms of the loan, that the adjustment may effect a change in the mortgage payment, the specific time period the current interest rate has been in effect, the dates of the upcoming and future interest rate adjustments, and any other changes to loan terms, features, or options taking effect on the same date as the interest rate adjustment; the due date of the first payment after the adjustment; for interest-only or negatively-amortizing payments, the amount of the current and new payment allocated to principal, interest, and taxes and insurance in escrow, as applicable; a statement regarding payment allocation for interest-only and negatively-amortizing loans, including the payment required to fully amortize an ARM that becomes negatively-amortizing as a result of the interest rate adjustment; any interest rate or payment limits and any foregone interest; if the new interest rate or new payment provided is an estimate, a statement that another disclosure containing the actual new interest rate and payment will be provided within a specified time period -- if the actual interest rate adjustment results in a corresponding payment change; and the amount and expiration date of any prepayment penalty and the circumstances under which such penalty might apply.

The proposed additional content, including the content that the Bureau interprets to be required under the statute, is authorized under TILA section 105(a). As further discussed below, the proposed additional content is necessary and proper to assure that consumers understand the consequences of the upcoming ARM rate adjustments and have sufficient time to adjust their behavior accordingly, thereby avoiding the uninformed use of credit and protecting consumers against inaccurate and unfair credit billing practices. The proposed additional content is further authorized under DFA section 1032 by assuring that the key features of consumers' adjustable-rate mortgage, over the term of the ARM, are "fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand [its] costs, benefits, and risks." The proposed additional information better informs consumers of the implications of interest-rate adjustments before they happen and thus enables them to weigh their options going forward. For the same reasons, the Bureau believes, consistent with DFA section 1405(b), that the proposed additional content would improve consumer awareness and understanding of their residential ARM loans and is thus in the interest of consumers and the public interest. The proposed additional content is also consistent with TILA section 128A(b) itself, which provides a non-exclusive list of required content, thereby statutorily contemplating additional content.

Good faith estimate. As noted above, TILA section 128A provides that the § 1026.20(d) interest rate adjustment disclosures should include "[a] good faith estimate, based on accepted industry standards . . . of the amount of the monthly payment that will apply after the date of the adjustment or reset, and the assumptions on which the estimate is based." ARM contracts generally provide that the calculation of the new interest rate and payment be based on an index value published closer to the date of the interest rate adjustment than those available during the time frame within which creditors, assignees, and servicers must provide the initial ARM interest rate adjustments pursuant to § 1026.20(d). 20(c)(2) above for a full discussion of the time frame generally required for ascertaining the index rate used to calculate the adjusted interest rate and new payment. Thus, it is unlikely creditors, assignees, and servicers will be able to disclose the actual new interest rate and payment in the initial ARM interest rate notices. For this reason, consistent with the language of the statute regarding estimates, proposed § 1026.20(d)(2) provides that if the new interest rate or any other calculation using the new interest rate is not known as of the date of the disclosure, use of an estimate, labeled as such, is permissible. The Bureau interprets the statutory good faith standard to require disclosure of the actual amounts if they are available at the time the creditor, assignee, or servicer provides the initial ARM interest rate adjustment notices to consumers pursuant to the time frame required by proposed § 1026.20(d). Since the notice is designed to alert consumers to upcoming changes to their mortgage and to provide consumers with the time needed to take ameliorative actions should the new interest rate and payment be too high, providing the actual new payment would benefit consumers. Across all rounds of consumer testing, most participants shown notices containing estimates of the new rate and payment understood that these amounts were estimates that could change before payment at a new level was due.[84]

To implement the requirements of TILA section 128A that the good faith estimate of the new payment be based on accepted industry standards, proposed § 1026.20(d) would require that any estimate be calculated using the index figure disclosed in the source of information described in proposed § 1026.20(d)(2)(iii)(A) within fifteen business days prior to the date of the disclosure. Linking the date of the notice to the date of the index value used to estimate the new interest rate and payment would prevent consumer confusion as to the recency of the index value. As discussed above under Section 20(c)(2), the fifteen-day period allows creditors,

[84] Macro Report, *supra* note 38, at viii.

assignees, and servicers sufficient time to calculate the estimates and perform any necessary quality control measures before providing the § 1026.20(d) notices to consumers.

20(d)(2)(i) Date of the Disclosure

Proposed § 1026.20(d)(2)(i) would require that the initial ARM adjustment notice include the date of the disclosure. In order to group together all data regarding the ARM, proposed § 1026.20(d)(3)(ii) would require that the date appear outside of and above the table described in proposed § 1026.20(d)(3)(i).

Proposed comment 20(d)(2)(i)-1 explains that the date would be the date the creditor, assignee, or servicer generates the notice. It also must be within fifteen business days after publication of the index level used to calculate the adjusted interest rate and new payment, if it is an estimate and not the actual adjusted interest rate and new payment.[85] Because the disclosures must be provided to consumers so far in advance, the Bureau expects estimates will be used in most cases. Tying the date of the disclosure to the date of the index level should prevent consumer confusion as to the recency of the index value upon which the estimated interest rate and new payment are based.

20(d)(2)(ii) Statement Regarding Change to Interest Rate and Payment

Proposed § 1026.20(d)(2)(ii)(A) would require the initial ARM interest rate adjustment notices to include a statement alerting consumers that, under the terms of their adjustable-rate mortgage, the specific period in which their interest rate stayed the same will end on a certain date, that their interest rate may change on that date, and that any change in their interest rate may result in a change to their mortgage payment. This information is similar to the information required to be disclosed in the pre-consummation disclosures provided to consumers pursuant to current § 1026.19(b)(2)(i) and § 1026.37(i), recently proposed in the 2012 TILA-RESPA Proposal. Proposed comment 20(d)(2)(ii)(A)-1 clarifies that the current interest rate is the one in effect on the date of the disclosure.

Proposed § 1026.20(d)(2)(ii)(B) would require the proposed initial ARM interest rate adjustment notices to include the dates of the impending and future interest rate adjustments and inform consumers that these changes are dictated by the terms of their adjustable-rate mortgages. Proposed § 1026.20(d)(2)(ii)(C) also would require the § 1026.20(d) disclosures to inform consumers of any other loan changes taking place on the same day as the adjustment, such as changes in amortization caused by the expiration of interest-only or payment-option features.

The first ARM model form tested did not contain the statement required by proposed § 1026.20(d)(2)(ii) informing consumers of impending and future changes to their interest rate and the basis for these changes. Although participants understood that their interest rate was adjusting and their payment might change as a result, they did not understand that these changes would occur periodically subject to the terms of their mortgage contract. Inclusion of this statement in the second round of testing successfully resolved this confusion. All but one consumer tested in rounds two and three of testing understood that, under the scenario presented to them, their interest rate would change on an annual basis.[86]

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[85] *See* proposed § 1026.20(d)(2).

[86] Macro Report, *supra* note 38, at vii.

20(d)(2)(iii) Table with Current and New Interest Rates and Payments

Proposed § 1026.20(d)(2)(iii) would require disclosure of the following information in the form of a table: (A) the current and new interest rates; (B) the current and new periodic payment amounts and the date the first new payment is due; and (C) for interest-only or negatively-amortizing payments, the amount of the current and estimated new payment allocated to interest, principal, and property taxes and mortgage-related insurance, as applicable. The information in this table would appear within the larger table containing the other required disclosures, except for the date of the disclosure.

This table would follow the same order as, and have headings and format substantially similar to, those in the table in Forms H-4(D)(3) and (4) in Appendix H of subpart C. The Bureau learned through consumer testing that, when presented with information in a logical order, consumers more easily grasped the complex concepts contained in the proposed § 1026.20(d) notice. For example, the form begins by informing consumers of the basic purpose of the notice: their interest rate is going to adjust, when it will adjust, and the adjustment will change their mortgage payment. This introduction is immediately followed by a visual illustration of this information in the form of a table comparing the consumers' current and new interest rates. Based on consumer testing, the Bureau believes that consumer understanding is enhanced by presenting the information in a simple manner, grouped together by concept, and in a specific order that allows consumers the opportunity to build upon knowledge gained. For these reasons, the Bureau proposes that creditors, assignees, or servicers disclose the information in the table as set forth in Forms H-4(D)(3) and (4) in Appendix H.

In all rounds of testing, consumers were presented with model forms with tables depicting a scenario in which the interest rate and payment would increase as a result of the adjustment. All participants in all rounds of testing understood that their interest rate and payment were going to increase and when these changes would occur.[87]

The Bureau proposes including allocation information in the table for interest-only and negatively-amortizing ARMs. The Bureau believes this information would help consumers better understand the risk of these products by demonstrating that their payments would not reduce the loan principal. The Bureau also believes providing the payment allocation would help consumers understand the effect of the interest rate adjustment, especially in the case of a change in the ARM's features coinciding with the interest rate adjustment, such as the expiration of an interest-only or payment-option feature. Since payment allocation may change over time, the proposed rule would require disclosure of the expected payment allocation for the first payment period during which the adjusted interest rate will apply.

The allocation of payment disclosure was tested in the third round of testing. The notice tested showed the scenario of a 3/1 hybrid ARM with interest-only payments for the first three years of the loan adjusting for the first time. On the date of the adjustment, the interest-only feature would expire and the ARM would become amortizing. Only about half of participants understood that their payments would be changing from interest-only to amortizing. Participants generally understood the concept of allocation of payments but were confused by the table in the notice that broke out principal and interest for the current payment, but combined the two for the

[87] *Id.*

new amount. As a result, this table was revised so that separate amounts for principal and interest were shown for all payments.[88]

The Bureau recognizes that certain Dodd-Frank Act amendments to TILA will restrict origination of non-amortizing and negatively-amortizing loans. For example, TILA section 129C and the 2011 ATR Proposal that would implement that provision, generally require creditors to determine that a consumer can repay a mortgage loan and include a requirement that these determinations assume a fully-amortizing loan. Thus, this law and regulation, when finalized, will restrict the origination of risky mortgages such as interest-only and negatively-amortizing ARMs.

Other Dodd-Frank amendments to TILA, such as the proposed periodic statement provisions discussed below, will provide payment allocation information to consumers for each billing cycle. Thus, consumers who currently have interest-only or negatively-amortizing loans or may obtain such loans in the future will receive information about the interest-only or negatively-amortizing features of their loans through the payment allocation information in the periodic statement. Also, as noted above, consumer testing showed that participants were confused by the allocation table. Since the Bureau was not able to test a revised version of the form to see if it rectified the confusion caused by the allocation table or if the concepts of non-amortizing and negatively-amortizing ARMs themselves are the source of the confusion, the Bureau questions the value of disclosing this information to consumers in the ARM interest rate adjustment notice. In view of these changes to the law and the outcome of consumer testing, the Bureau solicits comments on whether to include allocation information for interest-only and negatively-amortizing ARMs in the table proposed above.

20(d)(2)(iv) Explanation of How the Interest Rate is Determined

TILA section 128A mandates that the initial interest rate adjustment notices include any index or formula used in making adjustments to or resetting the interest rate, and a source of information about the index or formula. Accordingly, proposed § 1026.20(d)(2)(iv)(A) would require disclosure of the name and published source of the index or formula. This disclosure requirement is consistent with the pre-consummation disclosure requirements of current rule § 1026.19(b)(2)(iii). Proposed § 1026.37(i), part of the 2012 TILA-RESPA Proposal, likewise would require disclosure of the index name prior to consummation.

TILA section 128A also mandates that the initial interest rate disclosures include an explanation of how the new interest rate and payment would be determined, including an explanation of how the index was adjusted, such as by the addition of a margin. Proposed § 1026.20(d)(2)(iv) would require § 1026.20(d) notices to include an explanation of how the new interest rate is determined. This disclosure requirement is consistent with the pre-consummation disclosure requirements of current rule § 1026.19(b)(2)(iii). The 2012 TILA-RESPA Proposal's proposed 1026.37(i) likewise would require disclosure prior to consummation of the amount of the margin expressed as a percentage.

Consumer testing revealed that consumers generally have difficulty understanding the relationship of the index, margin, and interest rate.[89] Therefore, the Bureau is proposing a

[88] *Id.* at vii-viii. This revision was made after the third round of testing, and therefore was not tested with consumers.

relatively brief and simple explanation that the new interest rate is calculated by taking the published index rate and adding a certain number of percentage points, called the "margin." Proposed § 1026.20(d)(2)(iii) also includes the specific amount of the margin.

Consumer testing indicated that the explanation helped consumers better understand the relationship between the interest rate, index, and margin. It also helped dispel the notion held by many of the consumers in the initial rounds of testing that the lender subjectively determined their new interest rate at each adjustment.[90] The Bureau believes that its proposed rule and forms strike an appropriate balance between providing consumers with key information necessary to understand the basic interest rate adjustment of their adjustable-rate mortgages without overloading consumers with complex and confusing technical information.

20(d)(2)(v) Rate Limits

Proposed rule § 1026.20(d)(2)(v) would require the disclosure of any limits on the interest rate or payment increases at each adjustment and over the life of the loan. The Bureau believes that knowing the limitations of their ARM rates and payments would help consumers understand the consequences of each interest rate adjustment and weigh the relative benefits of the alternatives that would be required to be disclosed under proposed § 1026.20(d)(2)(viii). For example, if an adjustment might cause a significant increase in the consumer's payment, knowing how much more the interest rate or payment could increase could help inform a consumer's decision on whether or not to seek alternative financing.

Proposed § 1026.20(d)(2)(v) also requires disclosure of the extent to which the creditor, assignee, or servicer has foregone any increase in the interest rate. If there is foregone interest, it would require disclosure that the additional interest was not applied due to a rate limit and include the earliest date such foregone interest may be applied. Proposed comment 20(d)(2)(iv)-1 explains that disclosure of foregone interest would apply only to transactions permitting interest rate carryover. It further explains that the amount of increase foregone at the initial adjustment is the amount that, subject to rate caps, can be added to future interest rate adjustments to increase, or offset decreases in, the rate determined according to the index or formula.

Consumers had difficulty understanding the concept of interest rate carryover when it was introduced during the third round of testing. This difficulty may have been due to the simultaneous introduction of other complex notions, such as interest-only or negatively-amortizing features and the allocation of interest, principal, and escrow payments for such loans. In response, the Bureau has simplified the explanation of carryover interest.[91]

The Bureau recognizes that the disclosure of rate limits and unapplied carryover interest provide information that may help consumers better understand their ARMs. However, the Bureau is considering whether the help this information would provide outweighs its distraction from other more key information. Also, as explained above, consumers had difficulty understanding the concept of carryover interest and the Bureau is concerned this difficulty might diminish the effectiveness of the proposed § 1026.20(d) disclosures. The Bureau solicits

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[89] *Id.* at viii.
[90] *Id.*
[91] *Id.* at viii-ix.

comment on whether to include rate limits and unapplied carryover interest in the proposed § 1026.20(d) disclosures.

20(d)(2)(vi) Explanation of How the New Payment is Determined

TILA section 128A mandates that the initial interest rate notices include an explanation of how the new interest rate and payment would be determined, including an explanation of how the index was adjusted, such as by the addition of a margin. Proposed § 1026.20(d)(2)(vi) would implement this statutory provision by requiring the content discussed below. This proposed disclosure is consistent with the disclosures required at the time of application pursuant to current§ 1026.19(b)(2)(iii). It is also consistent with content required under proposed § 1026.20(c) and thus promotes consistency in Regulation Z ARM disclosures.

The disclosure required under proposed § 1026.20(d)(2)(vi) explains that the new payment is based on (A) the index or formula, (B) any adjustment to the index or formula, such as by addition of the margin, (C) the loan balance, (D) the length of the remaining loan term, and, (E) if the new interest rate or new payment provided is an estimate, a statement that another disclosure containing the actual new interest rate and new payment will be provided to the consumer 2 to 4 months prior to the date the first new payment is due, if the interest rate adjustment causes a corresponding change in payment, pursuant to section 1026.20(c).

The proposal would require disclosure of both the loan balance and the remaining loan term expected on the date of the interest rate adjustment. The proposed rule also would require disclosure of any change in the term or maturity of the loan caused by the adjustment.

As discussed in proposed § 1026.20(d)(2)(iv) above, the Bureau found that this explanation helped consumers better understand how the index or formula and margin determine their new payment and dispelled the notion held by many consumers in the initial rounds of testing that, at each adjustment, the lender subjectively determined their new interest rate, and thus the new payment. Disclosure of the four key assumptions upon which the new payment is based provides a succinct overview of how the interest rate adjustment works. It also demonstrates that factors other than the index can increase consumers' interest rates and payments. Disclosures of these factors would provide consumers with a snapshot of the current status of their adjustable-rate mortgages and with basic information to help them make decisions about keeping their current loan or shopping for alternatives. If an estimated new interest rate and new payment is used, the statement that the consumer will receive another disclosure with the actual new interest rate and new payment, if the interest rate adjustment results in a corresponding payment change, notifies consumers that the creditor, assignee, or servicer will inform them of the actual rate and payment two to four months in advance of the date their first new payment is due.

20(d)(2)(vii) Interest-Only and Negative-Amortization Statement and Payment

Proposed § 1026.20(d)(2)(vii) would require § 1026.20(d) notices to include a statement regarding the allocation of payments to principal and interest for interest-only or negatively-amortizing loans. If negative amortization occurs as a result of the interest rate adjustment, the proposed rule would require disclosure of the payment necessary to fully amortize such loans at the new interest rate over the remainder of the loan term. As explained in proposed comment 20(d)(2)(vii)-1, for interest-only loans, the statement would inform the consumer that the new payment covers all of the interest but none of the principal owed and, therefore, will not reduce the loan balance. For negatively-amortizing ARMs, the statement would inform the consumer that the new payment covers only part of the interest and none of the principal, and therefore the unpaid interest will add to the balance or increase the term of the loan.

Both current § 1026.20(c) and the Board's 2009 Closed-End Proposal to revise § 1026.20(c) include, for ARMs that become negatively amortizing as a result of the interest rate adjustment, disclosure of the payment necessary to fully amortize loans at the new interest rate over the remainder of the loan term. However, the Bureau believes there are countervailing considerations regarding whether to include this information in proposed § 1026.20(d).

The Bureau recognizes that certain Dodd-Frank Act amendments to TILA will restrict origination of non-amortizing and negatively-amortizing loans. For example, TILA section 129C and the 2011 ATR Proposal that would implement that provision, generally require creditors to determine that a consumer can repay a mortgage loan and include a requirement that these determinations assume a fully-amortizing loan. Thus, this law and regulation, when finalized, will restrict the origination of risky mortgages such as interest-only and negatively-amortizing ARMs.

Other Dodd-Frank Act amendments to TILA, such as the periodic statement proposed by § 1026.41, will include information about non-amortizing and negatively-amortizing loans in each billing cycle, such as an allocation of payments. Thus, consumers who currently have interest-only and negatively-amortizing ARMs or may obtain such loans in the future will receive certain information about the interest-only or negatively-amortizing features of their loans in another disclosure, although this will not include the payment required to fully amortize negatively-amortizing loans. The payment necessary to fully amortize these loans was not consumer tested but testing of the table showing the payment allocation of interest-only and negatively-amortizing ARMs indicated that consumers were confused by this concept. Thus, the Bureau is weighing the value of disclosing specific information regarding amortization, such as the payment needed to fully amortize negatively-amortizing ARMs. In view of these changes to the law and the outcome of consumer testing, the Bureau solicits comments on whether to include the payment required to amortize ARMs that became negatively amortizing as a result of an interest rate adjustment.

20(d)(2)(viii) List of Alternatives

TILA section 128A mandates that the initial interest rate adjustment notices include a list of alternatives consumers may pursue before adjustment or reset and descriptions of the actions consumers must take to pursue these alternatives. These alternatives include refinancing, renegotiation of loan terms, payment forbearance, and pre-foreclosure sales. Proposed § 1026.20(d)(2)(viii) would require disclosure in § 1026.20(d) initial ARM interest rate notices of the four alternatives set forth in the statute. The Bureau proposes to use simpler, commonly used terms in the model forms to describe the alternatives when possible.

The proposed model forms present the list as possibilities for consumers seeking alternatives to the upcoming changes to their interest rate and payment. The proposed forms also explain that most of the alternatives are subject to approval by the lender. All participants tested in the first and second round of testing were able to identify the list of alternatives.[92]

[92] *Id.* at viii.

The list of alternatives generally and concisely describes the actions consumers must take to pursue these alternatives, such as contacting their lender or another lender. Another action consumers may take to pursue these alternatives is contacting government organizations. Proposed § 1026.20(d)(2)(xi) would require disclosure in the initial ARM interest rate adjustment notice of information on how to contact such agencies, including the contact information for the State housing finance authority for the State in which the consumer resides and the website and telephone number to access the most current list of homeownership counselors or counseling organizations either made available by the Bureau or maintained by HUD. The Bureau proposes to require disclosure of this concise list of alternatives in lieu of a more detailed account of actions consumers may take in order to maximize the effectiveness of the disclosure without weighing it down with information that may not add significant value.

20(d)(ix) Prepayment Penalty

Proposed § 1026.20(c)(d)(ix) would require disclosure of the circumstances under which any prepayment penalty may be imposed, such as selling or refinancing the principal dwelling, the time period during which such penalty would apply, and the maximum dollar amount of the penalty. The proposed rule cross-references the definition of prepayment penalty in subpart E under § 1026.41(d)(7)(iv) in the proposed rule for periodic statements.

Interest rate adjustments may cause payment shock or require consumers to pay their mortgage at a rate they may no longer be able to afford, prompting them to consider alternatives such as refinancing. In order to fully understand the implications of such actions, the Bureau believes that consumers should know whether prepayment penalties may apply. Such information should include the maximum penalty (in dollars) that may apply and the time period during which the penalty may be imposed. The dollar amount of the penalty, as opposed to a percentage, is more meaningful to consumers.

The Bureau also proposes disclosure of any prepayment penalty in § 1026.20(c) ARM payment change notices and the periodic statements proposed by § 1026.41. Consumer testing of the periodic statement included a scenario in which a prepayment penalty applied. Most participants understood that a prepayment penalty applied if they paid off the balance of their loan early, but some participants were unclear whether it applied to the sale of the home, refinancing, or other alternative actions consumers could pursue in lieu of maintaining their adjustable-rate mortgages.[93] For this reason, the Bureau proposes to clarify the circumstances under which a prepayment penalty would apply. The proposed forms alert consumers that a prepayment penalty may apply if they pay off their loan, refinance, or sell their home before the stated date.

The Bureau recognizes that Dodd-Frank Act amendments to TILA, such as 129C and the 2011 ATR Proposal proposing to implement that provision, would significantly restrict a lender's ability to impose prepayment penalties. Other Dodd-Frank amendments to TILA, such as the proposed periodic statement, would provide consumers with information about their prepayment penalty for each billing cycle. Thus, consumers who currently have ARMs with prepayment penalty provisions or may obtain such loans in the future would generally receive information about them at frequent intervals in another disclosure. In view of these changes to

[93] *Id.* at vi.

the law, the Bureau solicits comments on whether to include information regarding prepayment penalties in proposed § 1026.20(d).

20(d)(2)(x) Telephone Number of Creditor, Assignee, or Servicer

Proposed § 1026.20(d)(2)(x) would require disclosure of the telephone number of the creditor, assignee, or servicer for consumers to call if they anticipate having problems paying the new payment.

20(d)(2)(xi) Contact Information for Government Agencies and Counseling Agencies or Programs

TILA section 128A mandates that the initial interest rate adjustment notices include the name, mailing and internet address, and telephone number of the State housing finance authority (as defined in § 1301 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989) for the State in which the consumer resides. Proposed § 1026.20(d)(2)(xi) would implement this statutory mandate by requiring inclusion of this information in the § 1026.20(d) initial interest rate adjustment notice. Two other mortgage servicing rulemakings proposed by the Bureau, the periodic statement, *see* below, and the early intervention for delinquent borrowers in the 2012 RESPA Servicing Proposal, also would require contact information for the State housing finance authority. However, those proposals would require the contact information for the State in which the property is located rather than in which the consumer resides, since the scope of those proposed rules is not limited to a consumer's principal dwelling. This is consistent with the proposed ARM rule since the consumer's principal dwelling should be located in the State in which the property is located. The Bureau seeks comment on how to address any compliance difficulties posed by this inconsistency.

TILA section 128A also mandates that the initial interest rate adjustment notices include the names, mailing and internet addresses, and telephone numbers of counseling agencies or programs reasonably available to the consumer that have been certified or approved and made publicly available by HUD or a State housing finance authority.

On July 9, 2012, the Bureau released proposed rules to implement other Dodd-Frank Act requirements expanding protections for "high-cost" mortgage loans under HOEPA, including a requirement that borrowers receive housing counseling (2012 HOEPA Proposal).[94] The 2012 HOEPA proposal also proposed to implement other homeownership-counseling-related requirements that are not amendments to HOEPA, including a proposed amendment to Regulation X that lenders provide a list of five homeownership counselors or counseling organizations to applicants for a federally related mortgage loan.[95]

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[94] *See* 2012 HOEPA Proposal, available at http://files.consumerfinance.gov/f/201207_cfpb_proposed-rule_high-cost-mortgage-protections.pdf, at 29-35.

[95] The list provided by the lender pursuant to the 2012 HOEPA Proposal would include only homeownership counselors or counseling organizations from either the most current list of homeownership counselors or counseling organizations made available by the Bureau for use by lenders, or the most current list maintained by HUD of homeownership counselors or counseling organizations certified by HUD, or otherwise approved by HUD. The 2012 HOEPA Proposal proposed that the list include five homeownership counselors or counseling organizations located in the zip code of the loan applicant's current address, or, if there are not the requisite five counselors or counseling organizations in that zip code, then counselors or organizations within the zip code or zip codes closest to the loan applicant's current address. To facilitate compliance with the proposed list requirement, the Bureau is

The Bureau has taken an alternative approach with regard to the initial ARM interest rate adjustment notice and proposes to use its exception authority to require creditors, assignees, and servicers simply to provide the website address to access either the Bureau list or the HUD list of homeownership counseling agencies and programs,[96] instead of requiring contact information for a list of specific counseling agencies or programs. The Bureau believes that this approach appropriately balances consumer and industry interests based on the following considerations:

The ARM notice required by proposed § 1026.20(d) has limited space and contains a significant amount of important technical information about the consumer's loan. Including too much information could overwhelm consumers and minimize the value of the other information contained in the notice. Also, not all consumers would benefit from the counselor information, although it would provide an important benefit for those consumers who face financial difficulties if their initial interest rate adjustment may cause their mortgage payments to significantly increase. Finally, importing updated information from the Bureau or HUD website would involve more programming burden than simply listing one of the agencies' websites.

Providing consumers with the website address for either the Bureau or HUD list of homeownership counseling agencies and programs would streamline the disclosure and present clear and concise information for the consumer to use. However, directing consumers to the actual list would allow them to choose a conveniently located program or agency and to locate other programs or agencies if those contacted initially could not help the consumer at that time. The Bureau seeks comment on whether this proposal strikes an appropriate balance, and on the benefits and burdens to both consumers and industry of requiring that a list of several individual housing counselors be included in the initial ARM interest rate adjustment notice.

Authority. The Bureau proposes to use its authority under TILA sections 105(a) and (f) and DFA section 1405(b) to exempt creditors, assignees, and servicers from the requirement in TILA section 128A to include in the initial ARM interest rate adjustment notice contact information for specific government-certified counseling agencies or programs reasonably available to the consumer, and its authority under TILA section 105(a) and DFA section 1405(b) to instead require that the initial ARM interest rate adjustment notice contain information that directs consumers to the Bureau list or HUD list of homeownership counselors or counseling agencies. For the reasons discussed above, the Bureau believes that the proposed exception and addition is necessary and proper under TILA section 105(a) both to effectuate the purposes of TILA -- to promote the informed use of credit and protect consumers against inaccurate and unfair credit billing practices -- and to facilitate compliance. Moreover, the Bureau believes, in light of the factors in TILA section 105(f), that disclosure of the government-certified counseling agencies or programs reasonably available to the consumer specified in TILA section 128A would not provide a meaningful benefit to consumers. Specifically, the Bureau considers that the exemption is proper irrespective of the amount of the loan and the status of the borrower (including related financial arrangements, financial sophistication, and the importance to the

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expecting to develop a website portal that would allow lenders to type in the loan applicant's zip code to generate the requisite list, which could then be printed for distribution to the loan applicant. *See* 2012 HOEPA Proposal at 31-32 (discussing proposed Regulation X § 1024.20(a)).

[96] At the time of publishing, the Bureau list was not yet available; the HUD list is available at http://www.hud.gov/offices/hsg/sfh/hcc/hcs.cfm.

borrower of the loan). The Bureau further notes, in light of TILA section 105(f)(2)(D), that the requirements in § 1026.20(d) would only apply to loans secured by the consumer's principal dwelling. Moreover, in the estimation of the Bureau, the proposed exemption would simplify the initial ARM adjustment notice and improve the housing counselor information provided to the consumer, thus furthering the consumer protection purposes of TILA. In addition, consistent with section 1405(b) of the Dodd-Frank Act, the Bureau believes that the proposed modification of the requirements in TILA section 128A would improve consumer awareness and understanding and is in the interest of consumers and in the public interest.

20(d)(3) Format of Initial Rate Adjustment Disclosures

As discussed above, the Bureau proposes to make proposed § 1026.20(d) subject to certain of the general form requirements of § 1026.17(a)(1), including requiring that the disclosure be clear and conspicuous, in writing, and in a form consumers can keep, and giving creditors, assignees, and servicers the option of providing the disclosures to consumers in electronic form, subject to compliance with consumer consent and other applicable provisions of the E-Sign Act. However, as discussed above, because § 1026.20(d) disclosures are subject to the statutory requirement that they must be provided separate and distinct from all other correspondence, the Bureau proposes to amend § 1026.17(a) to provide that the general segregation and grouping requirements in that provision would not apply to § 1026.20(d).

Authority. In addition, as described below, § 1026.20(d)(3) proposes additional form requirements for initial ARM adjustment notices. For the reasons described below, these requirements are authorized under TILA section 105(a) and DFA sections 1032(a) and 1405(b). As discussed in the section-by-section analysis for each of the proposed sections of § 1026.20(d)(3), the Bureau believes, consistent with TILA section 105(a), that the proposed formatting requirements are necessary and proper to effectuate the purposes of TILA to assure a meaningful disclosure of credit terms, to avoid the uninformed use of credit, and to protect consumers against inaccurate and unfair credit billing practices. Further the Bureau believes, consistent with DFA section 1032(a), that the proposed formatting requirements ensure that the features of the ARM loans covered by proposed § 1026.20(d) are fully, accurately, and effectively disclosed to consumers in a manner that permits them to understand the costs, benefits, and risks associated with such loans, in light of their individual facts and circumstances. Moreover, consistent with DFA section 1405(b), the Bureau believes that modification of the provision in TILA section 128A to require the proposed format discussed below would improve consumer awareness and understanding of residential mortgage loans transactions involving ARMs, and is thus in the interest of consumers and in the public interest.

20(d)(3)(i) All Disclosures in Tabular Form, Except the Date

Proposed § 1026.20(d)(3)(i) would require that, except for the date of the notice, the initial ARM adjustment disclosures be provided in the form of a table and in the same order as, and with headings and format substantially similar to, Forms H-4(D)(3) and (4) in Appendix H to subpart C for initial interest rate adjustments.

The proposed ARM adjustment notice contains complex concepts challenging for consumers to understand. For example, consumer testing revealed that participants generally had difficulty understanding the relationship among index, margin, and interest rate.[97] They also had difficulty with the concepts of amortization and interest rate carryover.[98] As a starting point, the Bureau looked at the model forms developed by the Board for its 2009 Closed-End Proposal to amend § 1026.20(c). The Bureau then conducted its own consumer testing.

The Bureau's testing showed that consumers can more readily understand these concepts when the information is presented to them in a simple manner and in the groupings contained in the model forms. The Bureau also observed that consumers more readily understood the concepts when they were presented in a logical order, with one concept presented as a foundation to understanding other concepts. For example, the form begins by informing consumers of the purpose of the form: that their interest rate is going to adjust, when it will adjust, and that the adjustment may change their mortgage payment. This introduction is immediately followed by a table visually showing the consumers' current and estimated new interest rates. In another example, the proposed notice informs consumers about their index rate and margin before explaining how the new payment is calculated based on those factors as well as other factors such as the loan balance and remaining loan term.

Based on consumer testing, the Bureau believes that consumer understanding is enhanced by presenting the information in a simple manner, grouped together by concept, and in a specific order that allows consumers the opportunity to build upon knowledge gained. For these reasons, the Bureau proposes that creditors, assignees, or servicers disclose the information required by proposed § 1026.20(d) with headings, content, and format substantially similar to Forms H-4(D)(3) and (4) in Appendix H to this part.

Over the course of consumer testing, participant comprehension improved with each successive iteration of the model form. As a result, the Bureau believes that displaying the information in tabular form focuses consumer attention and lends to greater understanding. Similarly, the Bureau found that the particular content and order of the information, as well as the specific headings and format used, presented the information in a way that consumers both could understand and from which they could benefit.

20(d)(3)(ii) Format of Date of Disclosure

Proposed § 1026.20(d)(3)(ii) would require that the date of the disclosure appear outside of and above the table required by proposed § 1026.20(d)(3)(i). As discussed above with respect to paragraph 20(d)(2)(i), the date would be segregated since it is not information specific to the consumer's adjustable-rate mortgage.

20(d)(3)(iii) Format of Interest Rate and Payment Table

Proposed § 1026.20(d)(3)(iii) would require tabular format for initial ARM interest rate adjustment notices for interest rates, payments, and the allocation of payments for loans that are interest-only or are negatively amortizing. This table would be located within the table proposed by § 1026.20(d)(3)(i). This table is substantially similar to the one tested by the Board for its 2009 Closed-End Proposal to revise § 1026.20(c). The proposal would require the table to follow the same order as, and have headings and format substantially similar to, Forms H-4(D)(3) and (4) in Appendix H of subpart C.

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[97] Macro Report, *supra* note 38, at viii.
[98] *Id.* at viii-ix.

Disclosing the current interest rate and payment in the same table allows consumers to readily compare them with the estimated or actual adjusted rate and new payment. Consumer testing revealed that nearly all participants were readily able to identify and understood the table and its contents.[99] The estimated or actual new interest rate and payment and date the first new payment is due is key information the consumer must know in order to commence payment at the new rate. For these reasons, the Bureau proposes locating this information prominently in the disclosure.

~~*Section 1026.36 Prohibited Acts or Practices in Connection with Credit Secured by a Dwelling*~~

~~*36(c) Servicing Practices*~~

~~Existing § 1026.36(c) provides requirements for servicers in connection with a consumer credit transaction secured by a consumer's principal dwelling. Essentially, such servicers must promptly credit payments, must not "pyramid" late fees, and must provide payoff statements at the consumer's request. The Dodd-Frank Act essentially codifies the § 1026.36(c) provisions on prompt crediting and payoff statements with minor changes, as discussed below. The Bureau is amending Regulation Z both to implement the new statutory requirements, and to address the related issue of the handling of partial payments. Currently, Regulation Z addresses prompt crediting in § 1026.36(c)(1)(i). The Bureau is proposing limiting the scope of existing § 1026.36(c)(1)(i) to full contractual payments, and addressing partial payments (anything less than a full contractual payment) in proposed § 1026.36(c)(1)(ii), as discussed below. The Bureau proposes to retain the substantive requirements on non-conforming payments currently in § 1026.36(c)(2), but to move them to paragraph (c)(1)(iii). Likewise, the Bureau does not propose to change the Regulation Z provision addressing "pyramiding" of late fees currently in § 1026.36(c)(1)(ii), but only to move the provision to new paragraph (c)(3). Finally, the Bureau is proposing four substantive changes to the provisions on payoff statements, currently located in § 1026.36(c)(1)(iii), as well as to move these provisions to proposed paragraph 36(c)(3).~~

~~The Bureau believes these changes to Regulation Z are best implemented by restructuring paragraph (c) and simplifying some of the language. This restructuring generally is not intended to make any substantive changes. All substantive changes to the paragraph (c) are discussed below.~~

~~*36(c)(1)(i) Full Contractual Payments*~~

~~DFA section 1464(a) established TILA section 129F, which codifies existing Regulation Z § 1026.36(c)(1)(i) with regard to prompt crediting of mortgage loan payments. The statute and the existing regulation both provide generally that "no servicer shall fail to credit a payment to the consumer's loan account as of the date of receipt, except when a delay in crediting does not result in any charge to the consumer or in the reporting of negative information to a consumer reporting agency." Proposed new paragraph (c)(1)(i) generally restates existing (c)(1)(i) with the only change that the existing regulation applies to all payments, while proposed (c)(1)(i) would be limited to full contractual payments. The Bureau is proposing to establish new § 1026.36(c)(1)(ii) to clarify servicers' obligations when they receive a partial payment (anything less than a full contractual payment), as discussed below.~~

[99] *Id.* at vii.