Consumer Compliance Outlook®

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A federal reserve system publication with a focus on consumer compliance issues

Right of Rescission in Times of Foreclosure

By Ken Shim, Senior Examiner, Federal Reserve Bank of New York

Reports of rising numbers of foreclosures continue to dominate the evening news. A joint report from the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) issued in March 2010 stated that for the institutions they supervise, mortgages classified as seriously delinquent (in bankruptcy or 60 or more days past due) increased 13.8 percent during the fourth quarter of 2009.[1] Serious delinquencies for prime mortgages, which make up two-thirds of the mortgages in the institutions' portfolios, showed a 75 percent increase from a year ago. The report further states that nearly 40 percent of residential mortgage loans for institutions supervised by the OCC and OTS that went through loan modification programs became seriously delinquent only 12 months after the modification. In this economic environment, the number of foreclosures is not likely to decline any time soon.

It is therefore important that lenders pay close attention to the rescission provisions of Regulation Z, the implementing regulation for the Truth in Lending Act (TILA). Rescission provides consumers with the right to rescind certain credit transactions secured by their principal dwelling for up to three business days after consummation. However, if creditors fail to provide borrowers with the notice of the right of rescission or the material TILA disclosures, the rescission period is extended to three years. Attorneys representing borrowers in foreclosure will typically scrutinize the notice and TILA disclosures for any violations that would extend the rescission period to three years.

TRANSACTIONS SUBJECT TO THE RIGHT OF RESCISSION

In general, the right of rescission applies to both open-end (§226.15) and closed-end (§226.23) consumer credit transactions secured by the consumer's principal dwelling. However, certain transactions are exempt. For open-end credit, §226.15(f) exempts a "residential mortgage transaction" (a loan to purchase or construct a principal dwelling) and a credit plan in which a state agency is a creditor. For closed-end credit, §226.23(f) exempts the following transactions: (1) a residential mortgage transaction; (2) a refinancing

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[1] See "OCC and OTS Mortgage Metrics Report, Fourth Quarter 2009," http://www.occ.treas.gov/ftp/release/2010-36a.pdf, p.14.

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The New Compliance Requirements Under Regulation Z for Private Education Loans

By John S. Insley, Jr., Principal Examiner, Federal Reserve Bank of Richmond

February 14, 2010 was the mandatory compliance deadline for the Board of Governors of the Federal Reserve System's (Board) recent amendments to Regulation Z for private education loans (PELs).[1] The amendments introduce new consumer protections and disclosures for PELs. Some lenders believe the new PEL rules do not apply to them because they do not have a formal student lending program, do not routinely arrange such loans, or do not promote loans to cover education expenses. However, any creditor who makes a PEL, as defined in §226.46(b)(5) of Regulation Z, is subject to the disclosure rules. This article provides an overview of those requirements to facilitate compliance.

SCOPE OF RULE

The Board adopted these amendments to implement the requirements of the Higher Education Opportunity Act of 2008 (HEOA),[2] which amended the Truth in Lending Act (TILA) to require new disclosures for PELs. Section 226.46(b)(5) of Regulation Z defines a PEL as a loan made to a consumer expressly, in whole or in part, for post-secondary educational expenses. The definition excludes open-end credit, real-estate-secured loans, loans extended by a covered institution of higher education for a term of 90 days or less, or loans for which the covered institution will not charge interest and whose term is for a year or less. The HEOA also amended TILA to cover PELs even if the amount financed exceeds $25,000.

The HEOA defines post-secondary educational expenses as any expenses listed as part of a student's cost of attendance, as that term is defined in §472 of the Higher Education Act of 1965 (HEA), 20 U.S.C. §1087ll,[3] at a covered educational institution. A covered educational institution is an educational institution that meets the definition of an institution of higher education, as defined in §§101-102 of the HEOA, 20 U.S.C. §§1001-1002, and the U.S. Department of Education implementing regulations, without regard to the institution's accreditation status. Such an institution may include, for example, a university or community college. It may also include an institution, whether accredited or unaccredited, offering instruction to prepare students for gainful employment in a recognized occupation. A

[1] The Board's July 30, 2009 announcement and the *Federal Register* notice are available on the Board's website at: http://www.federalreserve.gov/newsevents/press/bcreg/20090730a.htm.

[2] Public Law 110-315 available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110cong_public_laws&docid=f:publ315.110.pdf

[3] http://www.law.cornell.edu/uscode/html/uscode20/usc_sec_20_00001087--ll000-.html

covered educational institution does not include elementary or secondary schools.

Thus, unless otherwise exempted, a loan for which any portion of the proceeds will be used for the stated purpose of post-secondary educational expenses is a PEL and subject to the rules in §§226.46-48 of Regulation Z. The types of post-secondary educational expenses that if financed would trigger compliance with these rules are quite broad, including tuition and fees, books, supplies, miscellaneous personal expenses, room and board, and an allowance for any loan fee, origination fee, or insurance premium charged to a student or parent for a loan incurred to cover the cost of the student's attendance.

TIMING AND CONTENT OF DISCLOSURES

Section 226.46 establishes the timing requirements of the PEL disclosures, and §226.47 prescribes the content. Up to three separate sets of disclosures may be required under §226.47 for a single loan: disclosures at application or solicitation, disclosures after approval, and disclosures after acceptance. To facilitate compliance, the Board included model disclosure forms H-18, H-19, and H-20 in Appendix H of Regulation Z. For regulatory requirements linked to the receipt of disclosures, such as the right to cancel, the consumer is deemed to have received disclosures three business days after mailing.

The formatting requirements for disclosures, including required grouping, permissible additional items that may be included, conspicuousness of certain terminology, and requirements for electronic disclosure, are set forth in §226.46(c). As with Regulation Z's requirements for other credit products, the disclosures must reflect the terms of the legal obligation. Further, if any information necessary for an accurate disclosure is unknown to the creditor, the creditor must make the disclosure based on the best information reasonably available when the disclosure is provided and must clearly state that the disclosure is an estimate.

> AS WITH REGULATION Z'S REQUIREMENTS FOR OTHER CREDIT PRODUCTS, THE DISCLOSURES MUST REFLECT THE TERMS OF THE LEGAL OBLIGATION.

Disclosures with Application or Solicitation: §226.47(a)
The disclosures required by §226.47(a) are for an application or solicitation for a PEL. These disclosures may be provided orally for a telephone application or solicitation.

If a loan has an age or school enrollment eligibility requirement for the consumer or a co-signer, it must be disclosed. Additionally, the disclosures must include a statement that the consumer must complete the self-certification form before the loan can be consummated, and that the form may be obtained from the institution of higher education the student attends.[4]

The application disclosure must provide information about the cost of the loan – including information about interest rates, fees for obtaining the loan, and costs associated with default or late payment – as well as the terms of repayment.

If precise cost information for the specific loan cannot be determined at application, the lender is generally required to disclose a range of costs and explain how the costs will be determined. The term of the loan, which is the period during which regularly scheduled payments of principal and interest will be due, must be disclosed. If the consumer does not have the option to defer payments, the disclosures must state this fact. If the consumer can defer payments, the deferral features must be described, and for each deferral option applicable while the student is enrolled at a covered educational institution, disclosures must indicate:

- whether interest will accrue during the deferral period; and

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[4] This form is developed by the Secretary of Education, as required by §155 of the HEA and is available on the Department of Education's website at: https://ifap.ed.gov/dpcletters/attachments/GEN1001A-AppSelfCert.pdf.

RESPA Changes to the Good Faith Estimate Form

By Micah Spector, Assistant Examiner, Federal Reserve Bank of Philadelphia

In November 2008, the Department of Housing and Urban Development (HUD) published a final rule[1] to amend Regulation X, HUD's implementing regulation for the Real Estate Settlement Procedures Act (RESPA). The amendment made significant changes to the Good Faith Estimate (GFE) and the HUD-1 and HUD-1A uniform settlement statement forms effective January 1, 2010. The GFE is the form loan originators (lenders and mortgage brokers) must provide to consumers no later than three business days after receiving an application for a "federally related mortgage loan," as defined in §3500.2(b). The revised GFE is now a three-page form, reflecting the additional information lenders must now disclose.[2] HUD had several goals in revising the GFE:

- to reduce settlement costs by making it easier to shop among settlement service providers;
- to increase the accuracy of settlement costs listed on the GFE by improving disclosures of yield spread premiums (YSP);
- to facilitate comparison of the GFE and HUD-1/HUD-1A forms; and
- to strengthen RESPA's prohibition against the required use of affiliated businesses.[3]

This article is the first in a two-part series dealing with HUD's amendments to Regulation X. Part 1 reviews two important changes to the GFE: 1) changed circumstances, and 2) tolerance and cure. Part 2 will address HUD's changes to the HUD-1 form.

CHANGED CIRCUMSTANCES

While the GFE is intended to be an "estimate" of the loan terms and settlement costs and not an exact accounting, it must still be reasonably accurate. To this end, §3500.7(f) provides that "a loan originator is bound, within the tolerances provided in paragraph (e) of this section, to the settlement charges and terms listed on the GFE provided to the borrower, unless a new GFE is provided prior to settlement consistent with this paragraph (f)."

This section establishes that the loan originator is bound by the settlement charges and loan terms in the GFE unless one of the exceptions in §3500.7(f) applies. One important exception is for "changed circumstances." This term is defined in §3500.2 as:

1. an act of God, war, disaster, or other emergency;
2. information particular to the borrower or transaction that was relied on in providing the GFE and that changes or is found to be inaccurate after the GFE has been provided. This may include information about the credit quality of the borrower, the amount of the loan, the estimated value of the property, or any other information that was used in providing the GFE;
3. new information particular to the borrower or transaction that was not relied on in providing the GFE; or
4. other circumstances that are particular to the borrower or transaction, including boundary disputes, the need for flood insurance, or environmental problems.

Section 3500.2(b)(2) clarifies that changed circumstances do not include the borrower's name, the borrower's monthly income, the property address, an estimate of the property's value, the mortgage loan amount sought, and any information contained in any credit report obtained by the loan originator prior to providing the GFE, *unless the information changes or is found to be inaccurate after the GFE has been provided.* Also, market price fluctuations do not constitute changed circumstances.

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[1] 73 Fed. Reg. 68203 (November 17, 2008), available at: http://edocket.access.gpo.gov/2008/pdf/E8-27070.pdf

[2] The revised GFE form is available on HUD's website at: http://www.hud.gov/offices/hsg/ramh/res/gfestimate.pdf.

[3] 73 Fed. Reg. 68203, 68204. HUD also discussed its goals in "RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Final Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs," available at: http://www.hud.gov/offices/hsg/ramh/res/impactanalysis.pdf.

Regulation X places restrictions on the changes loan originators can make to settlement costs and loan terms as a result of changed circumstances. First, when a changed circumstance affects settlement costs or loan terms in excess of the applicable tolerance in §3500.7(e), and the loan originator intends to issue a revised GFE,[4] the originator must do so within three business days of receiving the information sufficient to establish the changed circumstance. Second, in revising the settlement costs or loan terms on the GFE because of the changed circumstance, the originator can change *only* those portions of the GFE directly affected by the changed circumstance. For example, if, after providing a GFE, a lender determines that a borrower's property is located in a special flood hazard area and requires flood insurance, that would constitute a changed circumstance for settlement costs. The lender would then have three business days to re-issue the GFE to add the cost of flood insurance, beginning from the time the lender discovered flood insurance was required. But the lender would not be allowed to change other settlement cost estimates. For instance, if interest rates increased between the date of the original GFE and the discovery that flood insurance is required, the loan originator could *not* change the rate on the loan, where the rate was locked in, because the rate was not affected by the changed circumstance of the flood insurance determination. Finally, when a changed circumstance results in a revised GFE, loan originators must retain documentation of the reasons for providing the revised GFE for no less than three years after settlement.

WHEN A CHANGED CIRCUMSTANCE RESULTS IN A REVISED GFE, LOAN ORIGINATORS MUST RETAIN DOCUMENTATION OF THE REASONS FOR PROVIDING THE REVISED GFE FOR NO LESS THAN THREE YEARS AFTER SETTLEMENT.

HUD has provided additional guidance about "changed circumstances" in its *New RESPA Rule FAQs* (FAQs).[5] The April 2, 2010 version of the FAQs includes 14 questions and answers on changed circumstances. For example, question 13 on p. 21 states:

Q: If the borrower selects a service provider that was not selected or identified by the loan originator, is this considered a changed circumstance?

A: No, if the borrower selects a service provider that was not selected or identified by the loan originator, it is not considered a changed circumstance.

Readers are encouraged to consult the latest version of the FAQs on HUD's website for additional guidance on "changed circumstances."

TOLERANCE AND CURE

To allow borrowers to shop for mortgage loans more easily and to reduce unexpected costs at settlement, the revised GFE rules place restrictions on increases in settlement costs from the amounts listed on the GFE to the amount on the HUD-1 form at settlement. Lenders are now responsible for the estimates of loan officers and mortgage brokers. Under §3500.7(f), the loan originator is bound by the settlement costs and loan terms subject to the tolerances in §3500.7(e). This section creates three buckets of tolerances, depending on the category of the settlement cost:

- zero tolerance for the origination charge, for the interest and adjusted origination charges during an interest rate lock period, and for transfer taxes;
- 10 percent tolerance (in the aggregate) for the following charges:
    a. when the lender requires the borrower to use a particular third-party settlement service provider;
    b. when the borrower selects a settlement service provider identified by the loan origina-

[4] A loan originator may choose to remain bound by the original GFE and not to issue a new one if the overall cost increase is minimal.

[5] http://nhl.gov/offices/hsg/ramh/res/respa_hm.cfm

tor for lender-required services, title services, and required title insurance; and
c. for government recording charges; and
- no restrictions for all other settlement charges.

The figures in Block 1 (Our Origination Charge), Block 2 (Your Credit or Charge (Points) for the Specific Interest Rate Chosen), Block A (Your Adjusted Origination Charges), and Block 8 (Transfer Taxes) are origination charges and therefore cannot increase from the GFE. These charges can be decreased and are also subject to the changed circumstances exception discussed earlier. The 10 percent tolerance threshold always applies to Blocks 3 (Required Services That We Select) and 7 (Government Recording Charges) and will apply to Blocks 4 (Title Services and Lender's Title Insurance), 5 (Owner's Title Insurance), and 6 (Required Services That You Can Shop For) unless the borrower selects a provider that is not on the "written list." The 10 percent tolerance never applies to Blocks 9 (Initial Deposit for Your Escrow Account), 10 (Daily Interest Charges), or 11 (Homeowner's Insurance), although the loan originator must still give estimated costs. The amounts charged for all other settlement costs can change at settlement. All the figures are entered into charts on the top of Page 3 of the HUD-1.

If the settlement costs listed on the HUD-1 exceed the amounts listed on the GFE by more than the applicable tolerance, "the lender is responsible for curing tolerance violations" (April 2, 2010 FAQs, p. 41, Q2). Regarding the amount that must be refunded and its timing, §3500.7(i) specifies that "if any charges at settlement exceed the charges listed on the GFE by more than the permitted tolerances, the loan originator may cure the tolerance violation by reimbursing to the borrower the amount by which the tolerance was exceeded, at settlement or within 30 calendar days after settlement." This is known as the right to cure. The lender must also disclose the corrected settlement amounts on a revised HUD-1 (April 2, 2010 FAQs, p. 42, Q9).

Note that loan originators cannot require borrowers to use specific providers in every situation. If the loan originator has an affiliate that provides, for example, tax services or a flood certificate, the loan originator may not require borrowers to use the services of affiliates. However, the loan originator may require borrowers to use a nonaffiliated service provider. The loan originator may include any affiliates on the "written list," provided the loan originator includes an affiliated business arrangement disclosure to the borrower when the GFE is sent to the borrower or the referral is made, whichever is earlier. (The rules governing affiliated business arrangements and required disclosures are in §3500.15.)

Block 4 for title services and lender's title insurance raises potential issues because this amount is often the largest of the values on the GFE and, therefore, has the largest potential for exceeding the 10 percent tolerance threshold. This can occur when loan originators fail to include all the ancillary items associated with the title service. Block 4 includes all charges associated with the title services and settlement (closing) agent services, including fees for settlement, abstract/title search, title examination, document preparation, associated attorney or notary fees, commitment/binder fees, wire fees, lender's title insurance, endorsements, courier/delivery fees, copying fees, electronic transmittal fees, and any other miscellaneous fees associated with title services performed for settlement. The amount in Block 4 should be the total of all of the preceding costs, even if paid to multiple sources. However, if any settlement charges are paid by the seller, they should not be included in Block 4.

Readers should consult the FAQs for additional guidance. The April 2, 2010 version includes 15 questions and answers on the right to cure and tolerance violations for sections 4 and 5.

CONCLUSION

HUD revised the GFE and HUD-1 forms to make the mortgage loan process more transparent to consumers, with fewer surprises at closing. The next issue of *Outlook* will discuss the changes to the HUD-1 under HUD's new Regulation X rules. Specific issues and questions should be raised with the consumer compliance contact at your Reserve Bank or with your primary regulator.

Compliance Alert

FINAL REMINDER FOR OVERDRAFT PROTECTION AND CREDIT CARD RULES

Consumer compliance regulations are changing at a fast pace, and the effective dates for overdraft protection rules and the implementation of the third phase of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (Credit CARD Act) are rapidly approaching. Both new rules require procedural and system changes. Have you executed your implementation plans and tested your systems?

Overdraft Protection

The new overdraft rules prohibit financial institutions from charging consumers fees for paying overdrafts on automated teller machine (ATM) and one-time debit card transactions, unless a consumer consents or opts in to the overdraft service for those types of transactions. Before opting in, the consumer must be provided with a notice that explains the financial institution's overdraft services, including the fees associated with the service and the consumer's choices.

The final rules (along with a model opt-in notice) were issued under Regulation E, which implements the Electronic Fund Transfer Act, in November 2009. Final clarifications, addressing questions that have arisen since the final overdraft rules were published and providing further guidance regarding compliance with certain aspects of the rules, were released on May 28, 2010.

Financial institutions should carefully review the compliance requirements, since those continuing to offer overdraft protection services must obtain opt-in approval from new customers for all accounts opened after July 1 and for all existing customers by August 15.

Credit CARD Act

On June 15, 2010, the Board of Governors of the Federal Reserve System approved a final rule amending Regulation Z (Truth in Lending) to protect credit card users from unreasonable late payment and other penalty fees and to require credit card issuers to reconsider increases in interest rates imposed since January 1, 2009.

The final rule is the third stage of the Federal Reserve's implementation of the Credit CARD Act, which was enacted in May 2009. Among other things, the final rule:

- Prohibits credit card issuers from charging a penalty fee of more than $25 for paying late or otherwise violating the account terms unless the consumer has engaged in repeated violations or the issuer can show that a higher fee represents a reasonable proportion of the costs it incurs as a result of violations.

- Prohibits credit card issuers from charging penalty fees (including late payment fees and fees for exceeding the credit limit) that exceed the dollar amount associated with the consumer's violation of the account terms. For example, card issuers will no longer be permitted to charge a $39 fee when a consumer is late making a $20 minimum payment. Instead, the fee could not exceed $20.

- Bans inactivity fees, such as fees based on the consumer's failure to use the account to make new purchases.

- Prevents issuers from charging multiple penalty fees based on a single late payment or other violation of the account terms.

- Requires credit card issuers to inform consumers of the reasons for increases in rates.

- Requires issuers that have increased rates since January 1, 2009, to evaluate whether the reasons for the increase have changed and, if appropriate, to reduce the rate.

The final rule will generally go into effect on August 22, 2010. The press release and the *Federal Register* notice are available at http://www.federalreserve.gov/newsevents/press/bcreg/20100615a.htm.

News From Washington: Regulatory Updates

Agencies propose to expand scope of Community Reinvestment Act (CRA) regulations to encourage depository institution support for the Department of Housing and Urban Development's (HUD) Neighborhood Stabilization Program (NSP) activities. On June 17, 2010, the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (Agencies) announced a proposed change to the CRA regulations to support stabilization of communities affected by high levels of foreclosure. The Agencies' proposal would encourage depository institutions to make loans and investments and provide services to support NSP activities in areas with HUD-approved plans. The proposal would supplement existing CRA consideration for community development activities, including neighborhood stabilization activities. NSP-eligible activities would receive favorable consideration under the new rule only if conducted within two years after the date when NSP program funds are required to be spent. The deadline for submitting comments on the proposed rule is July 26, 2010. The Agencies' announcement is available at: http://www.federalreserve.gov/newsevents/press/bcreg/20100617c.htm.

Agencies Announce Public Hearings on CRA Regulations. On June 17, 2010, the Agencies announced they will be conducting four public hearings on modernizing the regulations that implement the CRA to reflect changes in the financial services industry, changes in how banking services are delivered to consumers today, and current housing and community development needs. The planned hearing dates and cities are as follows: July 19, Arlington, VA; August 6, Atlanta; August 12, Chicago; and August 17, Los Angeles. Anyone wishing to submit testimony or attend the hearings must register five business days in advance on the website of the Federal Financial Institutions Examination Council at http://www.ffiec.gov/cra/hearings.htm. Hearing details are available on that site. In addition to having an opportunity to offer testimony at the hearings, individuals can submit written comments on these issues or any other aspect of the CRA to any of the agencies through August 31, 2010. While the agencies encourage public comments on any CRA topic, they are particularly interested in receiving comments on the topics and questions listed in the notice. The Agencies' announcement and the list of topics and questions are available at: http://www.federalreserve.gov/newsevents/press/bcreg/20100617b.htm.

Agencies release list of distressed or underserved nonmetropolitan middle-income geographies. On June 1, 2010, the federal bank and thrift regulatory agencies announced the availability of the 2010 list of distressed or underserved nonmetropolitan middle-income geographies where revitalization or stabilization activities will receive CRA consideration as "community development." The 2010 list incorporates a one-year lag period for geographies designated as distressed or underserved in 2009 but not designated as such in 2010. Geographies subject to this one-year lag period are eligible to receive consideration for community development activities for 12 months after publication of the 2010 list. The 2010 list and lists from previous years can be found on the Federal Financial Institutions Examination Council's website at: http://www.ffiec.gov/cra/examinations.htm.

The Board announces public hearings on potential revisions to Regulation C. On April 23, 2010, the Board announced that it will hold four public hearings, beginning in July, on potential revisions to Regulation C, which implements the Home Mortgage Disclosure Act. The hearings will serve three objectives: (1) to evaluate whether the 2002 revisions to Regulation C helped provide useful and accurate information about the mortgage market; (2) to gather information that will help the Board assess the need for additional data and other improvements; and (3) to identify emerging issues in the mortgage market that may warrant additional research. The hearings

will take place at the Federal Reserve Banks of Atlanta (July 15), San Francisco (August 5), and Chicago (September 16), and at the Federal Reserve Board in Washington, D.C. (September 24). All hearings will include panel discussions by invited speakers. Other interested parties may deliver oral statements of five minutes or less during an "open-mike" period. Written statements of any length may be submitted for the record. The press release is available at: http://www.federalreserve.gov/newsevents/press/bcreg/20100423a.htm.

Federal regulators release model consumer privacy notice online form builder. On April 15, 2010, eight federal regulators released an online form builder that financial institutions can download and use to develop and print customized versions of a model consumer privacy notice. Easy-to-follow instructions guide an institution to select the version of the model form that fits its practices, such as whether the institution provides an opt-out for consumers. To obtain a legal "safe harbor" and to satisfy the law's disclosure requirements, institutions must follow the instructions in the model form regulation when using the online form builder. The model privacy form was developed jointly by the Board, Commodity Futures Trading Commission, FDIC, Federal Trade Commission, National Credit Union Administration, OCC, OTS, and Securities and Exchange Commission. The press release and link to the online form builder are available at: http://www.federalreserve.gov/newsevents/press/bcreg/20100415a.htm.

The Board announces final rules to restrict fees and expiration dates on gift cards. On March 23, 2010, the Board announced final rules to restrict the fees and expiration dates that may apply to gift cards. The rules protect consumers from certain unexpected costs and require that gift card terms and conditions be clearly stated. The final rules prohibit dormancy, inactivity, and service fees on gift cards unless: (1) the consumer has not used the certificate or card for at least one year; (2) no more than one such fee is charged per month; and (3) the consumer is given clear and conspicuous disclosures about the fees. Expiration dates for funds underlying gift cards must be at least five years after the date of issuance or five years after the date when funds were last loaded. The final rules are issued under Regulation E to implement the gift card provisions in the Credit Card Accountability Responsibility and Disclosure Act of 2009 and are effective August 22, 2010. The press release and the *Federal Register* notice are available at: http://www.federalreserve.gov/newsevents/press/bcreg/20100323a.htm.

Financial Fraud Enforcement Task Force announces settlement with American International Group Inc. (AIG) subsidiaries to resolve allegations of lending discrimination. On March 4, 2010, the Financial Fraud Enforcement Task Force announced that two subsidiaries of AIG have agreed to pay a minimum of $6.1 million to resolve allegations that they engaged in a pattern or practice of discrimination against African American borrowers. Brought under the federal Fair Housing and Equal Credit Opportunity Act by the Department of Justice, the complaint alleges that African American borrowers nationwide were charged higher fees on wholesale loans made by AIG Federal Savings Bank and Wilmington Finance Inc., an affiliated mortgage lending company. "Today's settlement is significant because it marks the first time the Justice Department has held a lender responsible for failing to monitor its brokers to ensure that borrowers are not charged higher fees because of their race. If necessary, it will not be the last time," said Thomas E. Perez, assistant attorney general in charge of the Justice Department's Civil Rights Division. The press release can be found at: http://www.justice.gov/opa/pr/2010/March/10-crt-226.html.

On the Docket: Recent Federal Court Opinions*

REGULATION Z - TRUTH IN LENDING ACT (TILA)

Right of rescission applies only to consummated credit transactions. *Weintraub v. Quicken Loans, Inc.,* 594 F.3d 270 (4th Cir. 2010). The Fourth Circuit held that a borrower's right to rescind a mortgage loan under TILA does not apply until after consummation of a consumer credit transaction. The plaintiffs applied for a mortgage refinancing loan with Quicken Loans and provided a $500 deposit. At application, they were notified that in the event of cancellation, Quicken Loans would refund the deposit less any out-of-pocket costs. During underwriting, Quicken Loans added a half-point discount fee to the loan's closing costs after conducting an appraisal of the property and determining that it was worth $32,000 less than the plaintiffs' estimate of $340,000. In response, the plaintiffs sent Quicken Loans a "notice of right to cancel" and requested a refund of their deposit. Quicken Loans returned the deposit, less the costs of the appraisal and credit report fees. The plaintiffs filed a lawsuit alleging that Quicken Loans was required to refund the entire deposit once the plaintiffs invoked their right of rescission under §1635 of TILA. The issue on appeal was whether the right of rescission applies before a credit transaction is consummated. In analyzing this issue, the court focused on the language in §1635 stating that the right of rescission applies to a "consumer credit transaction." The court noted that TILA defines "transaction" with respect to a residential mortgage transaction, 15 U.S.C. §1602(w), and a reverse mortgage transaction, 15 U.S.C. §1602(bb), and both definitions treat "transaction" as a consummated credit event. Further, Regulation Z and its Official Staff Commentary (OSC) require that a security interest arise from a credit transaction before the right of rescission applies. The court concluded from this that "the right to rescind a transaction creating a security interest can only arise from a consummated transaction, because only upon consummation of the transaction is the security interest retained." The court therefore affirmed the dismissal of the case because the plaintiffs never consummated their credit transaction.

Court analyzes Regulation Z issues in reducing a home equity line of credit (HELOC). *Malcolm v. JPMorgan Chase Bank, N.A.,* 2010 WL 934252 (No. 09-4496, N.D. Cal. March 15, 2010). Plaintiff obtained a HELOC from JP Morgan Chase Bank, N.A. (Chase) in March 2006 based on his property's appraised value of $1 million. In August 2009, Chase notified the plaintiff that it was suspending future draws because the property's value had declined to $826,000 and no longer supported the HELOC. Plaintiff appealed the suspension and paid for an appraisal by a Chase-approved appraiser. That appraisal showed the property's value at $1.070 million, but Chase did not reinstate the HELOC and reimburse plaintiff the cost of the appraisal. Plaintiff filed a class-action lawsuit against Chase alleging violations of TILA with respect to Chase's procedures for suspending HELOCs based on property valuations. Chase filed a motion to dismiss the lawsuit, which the court granted in part and denied in part. Chase argued that its appraisal was reasonable when conducted and that a subsequent reappraisal does not establish that the initial appraisal was invalid. The court rejected this argument because the plaintiff's appraisal occurred within one month of Chase's appraisal, suggesting that Chase's appraisal was incorrect. Chase also argued that the plaintiff's claim that Chase violated TILA by relying on an automated valuation model (AVM) in reducing plaintiff's credit line was not a valid claim. The court dismissed this claim because neither TILA nor Regulation Z prohibits the use of an AVM for purposes of determining if a "significant" decline in property value has occurred, which would allow a suspension or reduction in a HELOC credit line. The plaintiff also argued that Chase violated TILA because the HELOC agreement permitted Chase to suspend the credit line even when the decline in property value amounted to

less than a 50 percent reduction in the difference between the credit limit and the borrower's available equity in the property. The court found that while the OSC states that a 50 percent reduction constitutes a significant decline, the OSC also suggests that a smaller reduction could be significant based on individual circumstances. Accordingly, the court rejected this claim.

REGULATION X - REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA)

Overcharges for settlement services do not violate RESPA §8(b). *Martinez v. Wells Fargo Home Mortgage, Inc.,* 598 F.3d 549 (9th Cir. 2010). The Ninth Circuit ruled that an overcharge for settlement services does not violate RESPA's ban on unearned fees under §8(b). The plaintiffs paid Wells Fargo an underwriting fee of $800 when they refinanced their mortgage. Their lawsuit alleged that the fee violates §8(b) of RESPA because the fee is not reasonably related to Wells Fargo's actual costs for performing the underwriting service. The court found that the text of §8(b) prohibits settlement service providers from charging fees when no services are provided but does not prohibit overcharges: "No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan *other than for services actually performed.*" The court also noted that three other circuit courts of appeals have concluded that §8(b) does not prohibit charging excessive fees for settlement services. *Friedman v. Market Street Mortgage Corp.,* 520 F.3d 1289, 1291 (11th Cir. 2008); *Santiago v. GMAC Mortgage Group, Inc.*, 417 F.3d 384, 385 (3d Cir. 2005); *Kruse v. Wells Fargo Home Mortgage, Inc.*, 383 F.3d 49, 56 (2d Cir. 2004). The Ninth Circuit therefore affirmed the lower court's dismissal of the case.

RESPA allows referral fees paid to employees. *McCullough v. Hanna,* (No. 09-2858 N.D. OH March 26, 2010). Plaintiff purchased residential real estate and was assisted in the transaction by Hanna, a business that provides real estate settlement services. Hanna provided the services through Barristers, with which Hanna has an affiliated business arrangement (ABA). Plaintiff filed a class action against Hanna and Barristers, alleging that Hanna violated RESPA's ban on referral fees under §8(a) by paying referral fees to its employees for referring class members to Barristers for settlement services. The court rejected the allegation because the plaintiff did not allege that Hanna paid referral fees to Barristers but rather to its own employees. The court noted that Regulation X, 24 C.F.R. §3500.14(g)(1)(vii), specifically states that "RESPA permits ... [a]n employer's payment to its own employees for any referral activities." Plaintiff also alleged that Hanna failed to comply with RESPA's requirements for disclosing an ABA. Under §8(c)(4) of RESPA, a business can make referrals to an affiliate if there are no kickbacks and the following requirements are satisfied: (1) the arrangement is disclosed prior to or at the time of the referral; (2) the person being referred is not required to use the referred service; and (3) nothing of value other than permissible payments is provided. Plaintiff alleged that Hanna violated RESPA by failing to comply with the ABA disclosure requirements. The court dismissed this claim because even if Hanna did not comply with these requirements, the plaintiff did not allege a prohibited kickback. The court found that failing to comply with the ABA disclosure requirements alone does not violate RESPA.

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* Links to the court opinions are available in the online version of *Outlook* at: http://www.consumercomplianceoutlook.org.

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Right of Rescission in Times of Foreclosure

by the same creditor for a previous extension of credit already secured by the consumer's principal dwelling; (3) a transaction in which a state agency is a creditor; (4) an advance, other than the initial advance, in a series of advances; and (5) a renewal of optional insurance premiums not considered a refinancing under §226.20(a)(5).

These exemptions can create ambiguities. For example, if a borrower offers her current residence as collateral to finance the construction or purchase of another property to be used as a principal residence in the near future, is the loan subject to rescission? The Official Staff Commentary (OSC) to Regulation Z addresses this issue in comment 226.23(a)(1)-4 for closed-end credit and comment 226.15(a)(1)-6 for open-end credit: Transactions such as bridge loans are subject to the right of rescission. The right of rescission also applies when the bridge loan is secured by both the current residence and the new property to be used as a principal residence. The consumer's current principal dwelling triggers rescission rights in this circumstance because the bridge loan is secured by the current dwelling and is not for the purpose of purchasing that dwelling. But if the consumer's construction loan for a new principal dwelling is secured only by the new dwelling, the loan would qualify as a residential mortgage transaction that is exempt from rescission.[2]

Another complex situation is whether the residential mortgage transaction exemption applies when a consumer obtains an open-end credit line and uses a portion of the line for a down payment to purchase a dwelling securing the remainder of the line. In this circumstance, comment 226.15(f)-1 clarifies that only the portion of the line used for the down payment is exempt from the right of rescission.

For refinancing of closed-end credit, the right of rescission applies under comment 226.23(f)-4 if a new creditor is involved or if a new advance is made by the existing creditor. A new advance does not include the cost of the refinancing, such as attorney's fees, title examination, and insurance fees, if bona fide and reasonable. It also does not include any finance charges paid or payable with the new loan.

Congress included the right of rescission in the TILA legislation to protect homeowners from the practices of unscrupulous home improvement contractors who obtain liens on their customers' houses, often without their customers' knowledge.

REGULATORY REQUIREMENTS

Congress included the right of rescission in the TILA legislation to protect homeowners from the practices of unscrupulous home improvement contractors who obtain liens on their customers' houses, often without their customers' knowledge. Representative John Sullivan stated that TILA's rescission requirements would "strike at home improvement racketeers who trick homeowners, particularly the poor, into signing contracts at exorbitant rates, which turn out to be liens on the family residences."[3]

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[2] Comments 226.23(a)(1)-3 and 226.15(a)(1)-5

[3] *Anderson Bros. Ford v. Valencia*, 452 U.S. 205, 221, footnote 19 (1981) (quoting Rep. Sullivan, 114 Cong. Rec. 14388 (1968)).

To protect homeowners from such abuses, Regulation Z requires lenders to provide, in addition to the TILA disclosure statement, two copies of the notice of the right to rescind to each consumer who has an ownership interest in the property. One copy is for the consumer to send to the lender to rescind the loan during the three-business-day period, and the other copy is for the consumer to keep for his or her records, since it contains important information about the consumer's rights and responsibilities. However, if the notice is delivered in electronic format in accordance with the Electronic Signatures in Global and National Commerce Act (the E-Sign Act), only one copy has to be provided to each consumer.[4] The notice must disclose the retention or acquisition of a security interest in the consumer's principal dwelling, the consumer's right to rescind, the procedure for the consumer to exercise the right, the effect of exercising the right of rescission, and the date the rescission period ends.

If the lender fails to provide a properly completed rescission notice or if the creditor fails to deliver any of the material disclosures, the consumer's right to rescind is extended for a period of three years.[5] For example, the United States Court of Appeals for the Seventh Circuit held in *Handy v. Anchor Mortgage Corporation,* 464 F.3d 760 (7th Cir. 2006), that the rescission period was extended from three business days to three years because the creditor provided the borrower with two different model rescission notice forms: H-8 (the general form) and H-9 (refinancing with original creditor). Form H-8 was appropriate for the transaction. The court held that providing two forms, one of which was incorrect for the transaction, violated TILA's "clear and conspicuous" requirements. Similarly, in *Harris v. OSI Financial Services, Inc.*, 595 F.Supp.2d 885 (N.D. Ill. 2009), the court extended the rescission period to three years because the creditor used model form H-8 when it should have used form H-9.[6]

Lenders are prohibited from disbursing the funds (other than in escrow), performing services for the consumer, or delivering materials to the consumer until the three-business-day rescission period has ended, and the lender has reasonable assurance that the consumer has not rescinded the transaction. Failure to comply with the three-business-day waiting period requirement can have serious consequences. For example, in *Rand Corporation v. Yer Song Moua*, 559 F.3d 842 (8th Cir. 2009), the Eighth Circuit held that a creditor who required borrowers to sign a statement at loan closing acknowledging receipt of the rescission notice and falsely stating that the three-day rescission period had passed and that the borrowers had not rescinded the transaction violated TILA and extended the rescission period from three business days to three years. The court cited numerous other decisions that reached the same conclusion.

All consumers with an ownership interest in the property that will be encumbered by the creditor's security interest must receive a rescission notice, even if they are not applying for credit. Only one consumer's exercise of the rescission right is necessary to rescind the loan. Therefore, lenders must be certain that each consumer with an ownership interest has agreed not to rescind by the end of the rescission period. The only time lenders are permitted to disburse the funds prior to the end of the rescission period is when the consumer requests the funds based on a bona fide personal financial emergency.[7]

The three-business-day rescission period begins following the date of consummation, delivery of two notices of the right to rescind to each consumer, or delivery of all material disclosures, whichever occurs last. For the purpose of the right of rescission, business day includes all calendar days except Sundays and legal public holidays. Lenders must disclose the last day for the consumer to rescind the loan by applying

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[4] Comments 226.15(b)-1 and 226.23(b)-1

[5] §226.15(a)(3); §226.23(a)(3)

[6] But note that the United States Court of Appeals for the First Circuit has rejected the Seventh Circuit's view that the use of the wrong model form automatically extends the rescission period. The First Circuit uses a more flexible approach that focuses on whether the creditor clearly and conspicuously informed the borrower of his right of rescission and its effects, even if the wrong form was used. *Santos-Rodriguez v. Doral Mortgage Corp.*, 485 F.3d 12 (1st Cir. 2007). The Eleventh Circuit uses a similar approach. *Veale v. Citibank, F.S.B.* 85 F.3d 577 (11th Cir. 1996).

[7] §226.15(e); §226.23(e)

this correct definition of business day. In *Cornerstone Mortgage, Inc. v. Ponzar*, 254 S.W.3d 221 (Mo.App. E.D. 2008), the creditor's rescission notice erroneously stated that the last day for the borrowers to exercise their right of rescission was January 15, 2006. The correct date was January 17, 2006, but the creditor failed to exclude Sunday and a legal holiday when calculating three business days. As a result, the court held that the rescission period was extended to three years. A related problem occurs when the creditor fails to disclose the deadline for exercising the right of rescission in the rescission notice. In *Johnson v. Chase Manhattan Bank USA, N.A.,* 2007 WL 2033833 (E.D.Pa. July 11, 2007), the court extended the rescission period to three years because the creditor left a blank in the deadline area of the rescission notice: "If you cancel by mail or telegram, you must send the notice no later than midnight of [left blank] (or midnight of the third business day following the latest of the three events listed above)."

It is important to understand the definition of "consummation" for the purpose of calculating the three-business-day rescission period. Section 226.2(a)(13) defines "consummation" as "the time that a consumer becomes contractually obligated on a credit transaction." Comment 226.2(a)(13)-1 clarifies that this determination must be made by reference to applicable state law. For example, in *Murphy v. Empire of America, FSA*, 746 F.2d 931, 934 (2d Cir. 1984), the Second Circuit concluded, based on New York law, that consummation occurred once the borrowers accepted the lender's commitment offer.

The meaning of "consummation" is also important for determining whether a consumer can exercise the right of rescission. The Fourth Circuit recently had to determine whether loan applicants could exercise the right of rescission for an unconsummated credit transaction. In *Weintraub v. Quicken Loans, Inc.,* 594 F.3d 270 (4th Cir. 2010), applicants who had been approved for a loan attempted to rescind it prior to closing to obtain a refund of their deposit because the rate increased. The court rejected their rescission request because it found that rescission applies only to consummated credit transactions, and the loan was never consummated. The *Weintraub* case is discussed in greater detail in "On the Docket" on page 10.

MATERIAL DISCLOSURES FOR THE PURPOSE OF RESCISSION

The three-business-day rescission clock commences following the date of consummation, delivery of two notices of the right to rescind, or delivery of all the material disclosures, whichever occurs last. Material disclosures are defined in footnote 36 of §226.15(a)(3) for open-end credit and in footnote 48 of §226.23(a)(3) for closed-end credit. For open-end transactions, the material disclosures are:

- the method of determining the finance charge and the balance upon which a finance charge will be imposed;
- the annual percentage rate (APR);
- the amount or method of determining the amount of any membership or participation fee that could be charged;
- the length of the draw period and any repayment period;
- an explanation of how the minimum payment is calculated;
- the timing of the payments; and
- if payment of only the minimum periodic payment may not repay any of the principal or may repay less than the outstanding balance, a statement of this fact as well as that a balloon payment may result.

For closed-end transactions, the material disclosures are:

- the APR;
- the finance charge;
- the amount financed;
- the total of payments;
- the payment schedule;
- the high-cost loan disclosures in §226.32(c) and restrictions in §226.32(d); and
- the restrictions on prepayment penalties for higher priced mortgage loans in §226.35(b)(2)

RESCISSION TOLERANCE

Creditors should be especially careful with disclosures for the APR, the finance charge, and the payment schedule because violations of these disclosures most frequently trigger the three-year rescission period. Section 226.23(g) provides a tolerance for errors in disclosures affected by the finance charge, including the amount financed and the APR. These disclo-

sures are considered accurate if the disclosed finance charge is understated by no more than 0.5 percent of the face amount of the note or $100, whichever is greater, or if it is overstated by any amount. For a refinance with a new creditor, the disclosures are considered accurate if the finance charge is understated by no more than 1 percent of the face amount of the note or $100, whichever is greater. A special rule applies when the consumer's principal dwelling securing a consumer credit transaction is in foreclosure. The disclosed finance charge is accurate if it is understated by no more than $35 or if it is overstated. Thus, the margin of error in foreclosure proceedings is lower.

The regulation does not provide any accuracy tolerances for the payment schedule disclosures. Therefore, any error involving this material disclosure can trigger a three-year rescission period. For example, in *Hamm v. Ameriquest Mortgage Company,* 506 F.3d 525 (7th Cir. 2007), the Seventh Circuit held that a creditor's disclosure statement that identified the payment amount and the number of payments (360) but failed to state that payments were due monthly violated TILA. As a result, the consumer was granted three years to exercise the right to rescind.

EXERCISING RESCISSION RIGHTS

Once the borrower exercises the right of rescission, any security interest the creditor obtained is void, regardless of its status and whether it was recorded or perfected. The borrower cannot be required to pay any amount to the lender or a third party in connection with the credit transaction. Any amounts already paid, including broker fees, application and commitment fees, or fees for a title search or an appraisal, must be refunded. Within 20 calendar days after receipt of the notice of rescission, the lender must take action to terminate the security interest and return any money in connection with the transaction. When the lender has complied with these requirements, the borrower must tender the money or property to the lender.[8] If the lender fails to take possession of the money or property within 20 calendar days after the borrower's tender, the borrower may keep it without further obligation. However, these procedures may be modified by court order.

STATUTE OF LIMITATION FOR RESCISSION

In cases where the right of rescission is extended to three years, the question has arisen whether courts can extend the three-year period. The United States Supreme Court addressed this issue in *Beach v. Ocwen Federal Bank*, 523 U.S. 410 (1998), where the court held that the borrower's right of rescission expires three years after the date of consummation of the transaction or upon the sale of the property, whichever occurs first, *even if the lender failed to provide all material disclosures or notice of the right of rescission.* The court based this conclusion on the express language in §125(f) of TILA (15 U.S.C. §1635(f)): "An obligor's right of rescission shall expire three years after the date of consummation of the transaction or upon the sale of the property, whichever occurs first, notwithstanding the fact that the information and forms required under this section or any other disclosures required under this part have not been delivered to the obligor."[9] This limitation on extending the three-year period also applies to mortgages in foreclosure under §125(i)(1) of TILA (15 U.S.C. §1635(i)(1)).

Another important limitation on the right of rescission concerns lawsuits seeking class-action certification for violations of the right of rescission. A number of courts have recently held that the right of rescission cannot be adjudicated in a class-action lawsuit because rescission raises individual issues that are not appropriate for class-wide determination. See *Andrews v. Chevy Chase Bank*, 545 F.3d 570 (7th Cir. 2008), *McKenna v. First Horizon Home Loan Corp*., 475 F.3d 418 (1st Cir. 2007), and *LaLiberte v. Pacific Mercantile Bank*, 53 Cal. Rptr.3d 745 (Cal. Ct. App. 2007).

In addition, institutions purchasing loans are subject to the right of rescission. Under §131(c) of TILA, (15

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[8] Some courts have denied a borrower's exercise of the right of rescission if the borrower is unable to return the loan proceeds to the creditor. See *American Mortg. Network, Inc. v. Shelton,* 486 F.3d 815, 819 (4th Cir. 2007); *Yamamoto v. Bank of New York,* 329 F.3d 1167, 1173 (9th Cir. 2003); *Williams v. Homestake Mortg. Co.*, 968 F.2d 1137, 1140 (11th Cir.1992).

[9] TILA does, however, contain a small exception when an agency empowered to enforce TILA initiates proceedings within three years of consummation, finds a violation, and the borrower's right of rescission is based in whole or in part on any matter in the proceedings. In that circumstance, the right of rescission is extended to one year after the conclusion of the agency proceedings or judicial review of the agency proceedings, whichever is later. See §125(f) of TILA (15 U.S.C. §1635(f)); §226.23(a)(3).

U.S.C. §1641(c)), any consumer who has the right to rescind a transaction may rescind against any assignee. See, for example, *Shepeard v. Quality Siding & Window Factory, Inc.*, 730 F.Supp. 1295 (D.Del. 1990) (allowing consumers to exercise rescission against an assignee).

CONCLUSION

The current mortgage crisis has made compliance with the requirements of the right of rescission under TILA more important than ever. Creditors must ensure compliance with Regulation Z technical rules related to rescission. At a minimum, lenders must establish clear and detailed procedures and provide sufficient training to their staff to ensure day-to-day compliance with these provisions. One mistake can result in a three-year rescission period and lost fees and interest over that period. Specific issues and questions should be raised with the consumer compliance contact at your Reserve Bank or with your primary regulator.

CONTINUED FROM PAGE 3...

The New Compliance Requirements Under Regulation Z for Private Education Loans

- if interest accrues, whether payment of interest may be deferred and added to the principal balance.

Section 226.47(a)(4) requires an example (using $5,000 or $10,000, depending on the maximum loan amount the creditor offers for such a loan) of the total cost of the loan. This disclosure is calculated as the total of payments over the term of the loan, for each payment option, using the highest rate of interest disclosed and including all finance charges applicable to loans at that rate. Concerning repayment, the application disclosure must contain a statement that if the consumer files for bankruptcy, the consumer may still be required to pay back the loan.

The lender must include on the application disclosure a statement that if the loan is approved, the terms of the loan will be available and will not change for 30 days except as a result of adjustments to the interest rate and other changes permitted by law. This reflects a consumer's substantive right under §226.48(c) to accept the terms of a PEL.

One key aspect of the legislation captured by the rule in §226.47(a)(6) is that the lender must disclose to the consumer information about alternatives to PELs, including:

- a statement that the consumer may qualify for federal student financial assistance through a program under Title IV of the HEA (20 U.S.C. 1070 et seq.);
- the interest rates available under each program under Title IV of the HEA (20 U.S.C. 1070 et seq.) and whether the rates are fixed or variable;
- a statement that the consumer may obtain additional information concerning federal student financial assistance from the institution of higher education the student attends or at the website of the U.S. Department of Education, including an appropriate website address; and
- a statement that a covered educational institution may have school-specific education loan benefits and terms not detailed on the disclosure form.

For multiple-purpose loans, a creditor generally will not know in advance whether the consumer intends to use the loan for post-secondary educational expenses. For this reason, the creditor is not required to provide the §226.47(a) disclosures on or with the application or solicitation for a multiple-purpose loan. However, if the consumer expressly indicates that the proceeds of the loan (not otherwise exempt) will be used to pay for post-secondary educational expenses, the creditor must adhere to the limitations detailed in §226.48 and comply with the approval and acceptance disclosure rules in §226.47(b) and (c), respectively. These requirements are discussed below.

Approval Disclosures: §226.47(b)

Before consummation of a PEL, on or with any notice of approval provided to the consumer, the lender must provide to the consumer in writing all of the disclosures required by §226.47(b). The approval disclosures capture information about the interest rate, fees and costs, repayment terms, alternatives to PEL loans, and the rights of the consumer.

Under the repayment terms disclosure, the lender must disclose, in addition to the specific costs and repayment terms, the loan amount for which the consumer has been approved. Using this amount, §226.47(b)(3)(vii) requires the lender to provide an estimate of the total amount of payments calculated based on:

- the interest rate applicable to the loan. Compliance with §226.18(h) (the total of payments) constitutes compliance with this requirement.
- the maximum possible rate of interest for the loan or, if a maximum rate cannot be determined, a rate of 25 percent.

If a maximum interest rate cannot be determined, the estimate of the total amount for repayment must include a statement that there is no maximum rate and that the total amount for repayment disclosed is an estimate and will be higher if the applicable interest rate increases.

Additionally, §226.47(b)(3)(viii) requires the lender to disclose the maximum monthly payment based on the maximum rate of interest for the loan or, if a maximum rate cannot be determined, a rate of 25 percent. If a maximum interest rate cannot be determined, the creditor must disclose that the loan is not subject to a maximum rate and that the monthly payment amount disclosed is an estimate and will be higher if the applicable interest rate increases.

For the disclosure concerning the consumer's rights, §226.47(b)(5)(ii) requires the lender to disclose that the rates and terms of the loan may not be changed by the creditor during the acceptance period, except for changes to the interest rate and other changes permitted by law. The approval disclosure must also include a statement that the consumer may accept the terms of the loan until the acceptance period — which must be at least 30 days under §226.48(c)(1) — has expired. The statement must include the specific date on which the acceptance period expires, based on the date the consumer received the disclosures. The disclosure must also specify the method or methods by which the consumer may communicate acceptance.

If a maximum interest rate cannot be determined, the estimate of the total amount for repayment must include a statement that there is no maximum rate and that the total amount for repayment disclosed is an estimate and will be higher if the applicable interest rate increases.

Inaccuracies in approval disclosures caused by events subsequent to delivery of the approval disclosures do not violate Regulation Z, and as a general rule, new approval disclosures are not required. However, a few exceptions are discussed below.

Final Disclosures: §226.47(c)

Final disclosures under §226.47(c) must be provided in writing after the consumer accepts the loan. In addition to the specific disclosures required under §226.47 for a PEL, lenders must provide the general closed-end TILA disclosures required by §226.18. Additionally, many of the disclosures required for the approval disclosure must be reiterated in the final disclosures, including:

- interest rate information required to be disclosed under §226.47(b)(1);
- information about fees and default or late payment costs required to be disclosed under §226.47(b)(2); and
- repayment terms information required to be disclosed under §226.47(b)(3).

Inaccuracies in the final disclosures are not violations if attributable to events occurring after disclosures are made and do not require new disclosures, unless one of the exceptions discussed later applies.

RIGHT TO CANCEL

Under §226.48(d), the consumer has the right to cancel a PEL without penalty for up to three business days after the consumer receives the final disclosures required under §226.47(c). Because of the right to cancel, loan proceeds cannot be disbursed until after the cancellation period expires. Lenders must include a statement of the right to cancel in the final disclosures. The statement must include the specific date on which the cancellation period expires and state that the consumer may cancel by that date. The disclosure must also specify the method or methods by which the consumer may cancel. If the creditor permits cancellation by mail, the statement must specify that the consumer's mailed request will be deemed timely if placed in the mail no later than the cancellation date specified on the disclosure. The statement of the right to cancel must be more conspicuous than any other disclosure required, except for the finance charge, the interest rate, and the creditor's identity, which must meet the conspicuousness requirements of section 226.46(c)(2)(iii). Model Form H-23 provides an example of the final disclosures, including the statement of the right to cancel.

RIGHTS AND LIMITATIONS

Section 226.48 establishes a number of substantive rights for consumers obtaining PELs. Among these is the right to accept the terms of a PEL at any time within 30 calendar days following the date on which the consumer receives the approval disclosures. With limited exceptions, the creditor cannot change the rate and terms of the loan during this 30-day period. Notwithstanding this general prohibition on change, certain changes are permissible under §226.48(c)(3) as follows:

- A creditor may withdraw an offer before consummation of the transaction if the extension of credit would be prohibited by law or if the creditor has reason to believe that the consumer has committed fraud in connection with the loan application;
- Based on adjustments to the index used for a loan, the interest rate may be changed;
- The interest rate and terms may be changed if the change will unequivocally benefit the consumer; or
- The loan amount may be reduced based upon a certification or other information received from the covered educational institution, or from the consumer, indicating that the student's cost of attendance has decreased or the consumer's other financial aid has increased. A creditor may make corresponding changes to the rate and other terms only to the extent that the consumer would have received the terms if the consumer had applied for the reduced loan amount.

None of the changes outlined above require the creditor to provide new approval disclosures or an additional 30-day period for the consumer to accept the new terms of the loan; however, final disclosures must be provided to reflect the changed terms.

In some circumstances, new approval disclosures are required. A creditor may change the rate or terms of the loan to accommodate a specific request by the consumer. For example, if the consumer requests a different repayment option, the creditor may, but need not, offer to provide the requested repayment option and make any other changes to the rate and terms. If the creditor does change the rate or terms at the consumer's request, it must provide the approval disclosures required under §228.47(b) and provide the consumer the 30-day period to accept the loan. The creditor cannot make further changes to the rates and terms of the loan, except as permitted under §226.48(c)(3). Further, unless the consumer accepts the loan offered by the creditor in response to the consumer's request, the creditor may not withdraw or change the rates or terms (except as permitted by the regulation) of the loan for which the consumer was approved prior to the consumer's request for a change in loan terms.

A number of other limitations on PELs are contained in §226.48 that generally cover the marketing of such loans and certain relationships between lenders and educational institutions. Section 226.48(a) generally prohibits co-branding. This prohibition means that a creditor, other than the covered educational institution itself, cannot use the name, emblem, mascot, or logo of a covered educational institution, or other words, pictures, or symbols identified with a covered

educational institution, in the marketing of PELs in a way that implies that the covered educational institution endorses the creditor's loans.

The rule permits co-branding when a creditor and a covered educational institution have entered into an endorsed lender arrangement and certain disclosures are made to a consumer. An endorsed lender arrangement exists when a creditor and a covered educational institution have entered into an agreement in which the covered educational institution agrees to endorse the creditor's PELs, and such arrangement is not prohibited by other applicable law or regulation. To take advantage of the exception to the co-branding prohibition, PEL marketing must include a clear and conspicuous disclosure that is equally prominent and closely proximate to the reference to the covered educational institution that the creditor's loans are not offered or made by the covered educational institution but are made by the creditor.

THE RULE PERMITS CO-BRANDING WHEN A CREDITOR AND A COVERED EDUCATIONAL INSTITUTION HAVE ENTERED INTO AN ENDORSED LENDER ARRANGEMENT AND CERTAIN DISCLOSURES ARE MADE TO A CONSUMER.

Finally, §226.48(f) establishes a requirement that a creditor that has a preferred lender arrangement with a covered educational institution must provide information to the covered educational institution about the PELs it will be offering to students at the institution. Under the regulation, a preferred lender arrangement has the same meaning as in §151(8) of the Higher Education Act of 1965, 20 U.S.C. §1019(8). Generally, such an arrangement exists between a lender and a covered educational institution or an institution-affiliated organization of such covered institution when a lender makes education loans to students, or families of students, attending the covered institution and involves the covered institution, or such institution-affiliated organization, recommending, promoting, or endorsing the education loan products of the lender.

When aware of a preferred lender arrangement with a covered educational institution, a creditor must provide the institution with the information required under §226.47(a)(1)-(5) (certain cost, repayment, and loan eligibility information that must be included in application disclosures), for each type of PEL the lender plans to offer to consumers for students attending the covered educational institution for the period beginning July 1 of the current year and ending June 30 of the following year. The creditor must provide the information annually by the later of the 1st day of April, or within 30 days after entering into, or learning the creditor is a party to, a preferred lender arrangement.

It is possible for a preferred lender arrangement to exist without the knowledge of a lender. For this reason, comment 226.48(f)-1 of the Official Staff Commentary provides that a creditor is subject to the requirements of this section only if the creditor is aware that it is a party to a preferred lender arrangement. For example, if a creditor is placed on a covered educational institution's preferred lender list without the creditor's knowledge, the creditor is not required to comply with §226.48(f).

CONCLUSION

A lender may find that it has historically made, even if only occasionally, loans that now meet the definition of a PEL. Before extending any PELs, lenders should ensure that they have the capacity to comply with these new rules. If disclosure software is purchased from a vendor, the lender will likely want to inquire about the availability and cost of updates for supporting compliance with the new rules. Even if few such transactions are originated, the inability to generate correct disclosures when required would result in violations of Regulation Z. Specific issues and questions should be raised with the consumer compliance contact at your Reserve Bank or with your primary regulator.

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Calendar of Events

July 15 — **Home Mortgage Disclosure Act (HMDA) Public Hearing**
Federal Reserve Bank of Atlanta
Atlanta, GA

July 19 — **Community Reinvestment Act (CRA) Public Hearing**
FDIC Seidman Center
Arlington, VA

August 5 — **HMDA Public Hearing**
Federal Reserve Bank of San Francisco
San Francisco, CA

August 6 — **CRA Public Hearing**
Federal Reserve Bank of Atlanta
Atlanta, GA

August 12 — **CRA Public Hearing**
Federal Reserve Bank of Chicago
Chicago, IL

August 17 — **CRA Public Hearing**
Los Angeles Branch of the Federal Reserve Bank of San Francisco
Los Angeles, CA

September 16 — **HMDA Public Hearing**
Federal Reserve Bank of Chicago
Chicago, IL

September 24 — **HMDA Public Hearing**
Board of Governors of the Federal Reserve System
Washington, D.C.