PUTTING SOME TEETH IN TILA: FROM DISCLOSURE TO SUBSTANTIVE REGULATION IN THE MORTGAGE REFORM AND ANTI-PREDATORY LENDING ACT OF 2010

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INTRODUCTION

Give the consumers the information they need to make rational choices in the credit marketplace, and then sit back and let the free market do its magic. This has long been the philosophy of federal credit regulation, from the passage of the Truth in Lending Act ("TILA") in 1968 until recent times. Disclosure regulation is a perennial favorite of legislators and regulators, as well as industry, because it is less costly and less interfering than price controls, such as the old usury laws, or other types of substantive regulation. Almost from its inception, however, it was recognized that there were problems with the disclosure approach, such as too much clutter, too many technical violations and too much information for consumers to use. For many years the response to these issues was to try to improve the disclosures, first by simplification, and also by improving the timing in which they are given. And yet studies showed that consumers did not, or could not, use the mandated disclosures to make good choices. Behavioral economists demonstrated that there are very daunting cognitive and behavioral obstacles that prevent many consumers from using the information provided. The recent subprime mortgage crisis brought to the forefront the fact that the TILA disclosures were powerless to prevent or dissuade consumers from obligating themselves to potentially disastrous mortgage transactions. One powerful response to these developments is found in the Mortgage Reform and Anti-Predatory

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Lending Act of 2010, one title of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This law, which includes many revisions to TILA in the area of home-secured credit transactions, takes a much more substantive regulatory approach than has been seen until recently in federal credit regulation.

This article will first provide a brief overview of the history of the disclosure approach taken by TILA, from its inception through various reform measures that attempted to improve the disclosures required under the law. Next, the scholarship elucidating the practical limitations of disclosure as consumer protection, especially in residential subprime mortgage transactions, will be summarized. The specific substantive provisions to protect consumers of residential mortgage loans under the new legislation will be surveyed, accompanied by a discussion of why disclosure alone was inadequate in each of these targeted areas. Finally, the costs and benefits of substantive regulations as opposed to disclosure alone will be discussed. The article concludes that the failure of the pure disclosure approach has necessitated more substantive restrictions on consumer credit in the residential mortgage market. However, these substantive provisions work best when focused on specific abuses, and should not be considered as a total replacement for disclosures, but rather as a complement to disclosure for particular issues that cannot be remedied by disclosure alone.

I. HISTORY OF DISCLOSURE REGULATION UNDER TILA

The mother of all federal consumer credit laws, the Truth in Lending Act, was conceived as a disclosure law when it was debated and passed by Congress in the late 1960s.1 Disclosure was considered the perfect form of consumer protection because it supported the free market by providing consumers with informed choices without banning any particular credit offering.2 It was also the least costly and most politically acceptable method of regulation.3 Prior to the passage of TILA in 1968, consumers were confused and misled by

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creditors who were using conflicting methods for measuring the cost of credit, including discount rates, add-on rates and standard interest rates applied to a declining balance.\textsuperscript{4} There was also variation in what creditors revealed about the total finance charge.\textsuperscript{5} Creditors were not required to disclose anything about the cost of credit prior to a transaction, regardless of the measurement method used.\textsuperscript{6} Consequently, comparative shopping was difficult or impossible under these conditions.

The Truth in Lending Act, which is one title of the umbrella Consumer Credit Protection Act, took a pure disclosure approach. Such an approach was in contrast to the preceding approach under state law, which mainly sought to cap the price of consumer credit through usury statutes. The problem with state usury laws was that the definition of the interest rate that was capped was full of loopholes and was easily evaded.\textsuperscript{7} Economists vigorously criticized such price control laws as skewing the true market price of the product, i.e., consumer credit, because price controls, by definition, do not allow competition in the marketplace to set the price.\textsuperscript{8} However, as the TILA drafters realized, competition in the consumer credit sector could not, and would not, work well if the consumers were unable to ascertain comparable prices for competing credit offerings. Therefore, TILA’s approach of having a uniform cost of credit, particularly the federally defined Annual Percentage Rate, or APR and the finance charge, disclosed prior to consummation of a credit transaction, was viewed as a way to remedy the market failure posed by non-uniform pricing.\textsuperscript{9} Also, the TILA credit cost disclosure approach was deemed to promote better consumer choices and more vigorous competition in the marketplace.

It is a basic assumption of the competitive model that all market participants, buyers and sellers, possess “perfect information” that aids in seeking out the best market offerings to meet needs. If consumers, such as credit consumers prior to the enactment of TILA, do not possess and cannot obtain such information about competing

\textsuperscript{5} Id.
\textsuperscript{6} Id.
\textsuperscript{8} Id.
offerings, the market breaks down. Thus, simply providing consumers with the information they need to make rational choices protects both consumers and the free market and is an approach that gains supporters from both classical economists and consumer advocates. Fully-informed, rational consumers, under a pure disclosure regime, simply select the best choice of credit offerings based on perfect information, while creditors are forced to compete with each other to gain the favor of such fully-informed buyers.

In the ensuing years after the passage of TILA, it became clear that the TILA disclosures were too complex and too poorly presented to achieve their goals of promoting a competitive consumer credit market. The disclosures did not have much impact because consumers could not understand them and did not have the opportunity to use them for comparison shopping. Disclosures were given shortly before the signing of the credit contract, a time when the consumer is already psychologically committed to the deal, and is probably not inclined to comparison shop. TILA also required disclosure of numerous items in addition to the APR and finance charge that cluttered the process in ways that made the critical information difficult for consumers to find. Creditors also complained about the complexity of the disclosures as well as the flood of litigation alleging various technical violations. This sparked a movement to simplify the disclosures, which came to fruition in the Truth in Lending Simplification and Reform Act of 1980.

One of the main purposes of this first major overhaul of TILA was to provide consumers with simpler, more understandable information. Disclosures were reduced and a new formatting

12 Id.
15 Id.
requirement, “the Federal Box,” was inaugurated. The Federal Box basically required all TILA disclosures to be segregated from the contract terms, with the APR and finance charge disclosures receiving the most prominence. The Federal Reserve Board also created model forms to provide guidance to creditors on how to comply with the law. These reforms were supposed to eliminate the problems of information overload and the obscuration of key terms that consumers needed for comparison shopping.

Until recently, despite its shortcomings, disclosure remained a preferred approach to problems in consumer credit, with various attempts being made over the years to continue to improve the timing, formatting and wording so as to make the disclosures more useful to consumers. In the mortgage area specifically, TILA and Regulation Z have long provided that consumers be given early estimated disclosures of credit costs, within three days of receipt of the consumer’s application by the lender. Recognizing the importance of providing early disclosures of credit costs, when consumers are still in a position to comparison shop, Congress passed the Fair Credit and Charge Card Disclosure Act of 1988. The Act requires early disclosures in a readable, tabular format in most solicitations for credit or charge cards, before the consumer has even filled out an application. But standard closed-end consumer credit loan disclosures, such as an automobile loan, continue to be provided late in the process, typically in conjunction with consummation of the transaction. The consumer may not see the TILA disclosures until seconds before they sign the credit agreement.

Despite early disclosures for residential mortgage loans, the

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21 The early disclosure requirement for residential mortgage transactions covered by the Real Estate Settlement Procedures Act has been a part of TILA since the 1980 Simplification Act. This requirement is now applicable to all mortgage loans secured by a consumer’s dwelling. 12 C.F.R. § 226.19(a)(1)(i) (2009).


23 12 C.F.R. § 226.17(b).

24 See, e.g., Spearman v. Tom Wood Pontiac-GMC, Inc., 312 F.3d 848 (7th Cir. 2002).
problem of complexity and information overload has continually plagued this area of consumer credit. Since the 1970s and 80s, residential mortgage loans have been offered with variable or adjustable rates, which necessitated more complex disclosures due to the increased complexity of the transactions. Special adjustable rate mortgage (“ARM”) disclosures, including a general consumer information booklet, have been a part of the TILA disclosure regime since the 1980s. In 2009, the Federal Reserve Board proposed a new round of amendments to the ARM disclosures that would streamline the application disclosure and require transaction-specific disclosure within three days of when the lender receives an application. One inherent problem with ARM disclosures, however, has always been that there is no one APR or finance charge that a consumer could use for comparison shopping with this type of mortgage. Similarly, Home Equity Lines of Credit, or HELOCs, a type of open-end credit secured by the existing equity in a consumer’s home, also called for special TILA disclosures due to the characteristics of these loans. Thus Congress amended TILA in 1988 to require improved disclosures for HELOCs. As with ARM disclosures, revisions of the HELOC disclosures were proposed in 2009, but have not yet gone into effect. Due to the complex and inherently variable and unpredictable nature of these transactions, however, the disclosure approach, no matter how consumer-friendly it becomes, may not achieve the ideal TILA model of informed consumers spurring a competitive consumer credit market.

Thus, over the decades after the passage of TILA, the credit products being offered, especially in residential mortgages or dwelling-secured transactions, were becoming more and more complex and the disclosure regime was struggling to keep up with the information needed to make rational choices in this environment.

25 Truth in Lending, 74 Fed. Reg. 43232 (Aug. 26, 2009). These proposed regulations are on hold due to the creation of the Consumer Financial Protection Bureau which now has jurisdiction over consumer credit regulation.
29 See infra text accompanying footnotes 54-56, discussing the cognitive limitations most consumers experience in processing complicated mortgage loan disclosures.
Nonetheless, the predominant regulatory response was to tinker with the complicated disclosures to attempt to make them more accessible and understandable to the consumers who were expected to use them. By the 1990s and 2000s, however, a new wave of scholarship focusing on behavioral economics pointed out the limits of consumer disclosures for the type of complex credit transactions that were being offered. It was argued that even a rational consumer faces almost insurmountable cognitive obstacles in seeking to understand TILA disclosures and to use them in making rational choices, especially in the context of subprime real estate transactions. 

II. THE LIMITS OF DISCLOSURE REGULATION IN THE RESIDENTIAL MORTGAGE MARKET

The pure disclosure approach to consumer protection may have reached its peak utility. Mandated disclosure has become so pervasive over the past fifty years, that the flood of information may well be drowning consumers. Disclosures have ranged well beyond the consumer credit area, and into areas of informed consent for health care decisions, product warnings, and consumer contract boilerplate clauses – which are now presented in scroll down boxes that pop up on computer screens with the ubiquitous requirement that the consumer click “I agree” before proceeding with their purchase. The sheer accumulation of consumer disclosures may have the unintended and unhelpful effect of becoming almost universally ignored by their intended beneficiaries.

The disinclination or inability to use the mandated information has become particularly acute in the area of home-secured consumer credit. A Federal Trade Commission (“FTC”) study published in 2007 found that the required mortgage cost disclosures did not accomplish the goal of conveying pertinent mortgage costs to consumers. The FTC study surveyed consumers who had recently taken home-secured mortgages, and even in a quiet, unhurried laboratory setting, about one-third of the respondents could not identify which of two loans was less expensive, half could not

30 See infra text accompanying footnotes 31-45.
correctly identify the loan amount, two-thirds did not recognize that they would be charged a prepayment penalty if they refinanced with another lender within two years, and almost four-fifths did not know why the interest rate and the APR of a loan sometimes differ.\footnote{Id.}

Another more recent survey by Professor Jeff Sovern demonstrated that mortgage brokers reported that borrowers never withdrew from a loan after reading the final TILA disclosures, never used the disclosures for comparison shopping for loans, and that most borrowers spent very little time with the disclosures, despite the amount of money at stake and the length and complexity of the disclosures.\footnote{Id.}

As the subprime mortgage crisis unfolded, it became clear that certain types of “exotic” or “toxic” real-estate loans were being offered to subprime borrowers, who were likely to accept the terms without being fully aware of the actual costs and pitfalls involved, despite the presence of TILA disclosures. First, while ARMs have been around for a while, there was recently a higher prevalence of hybrid ARMs, which pose more traps for the unwary consumer. These hybrid ARMs featured a relatively low fixed rate for an introductory period, followed by an adjustable rate period with a large spike in the monthly payment.\footnote{Id.} Another type of product that defied consumer comprehension of risks were the so-called “payment-option ARMs,” which allowed the borrower to choose varying payment levels, the lowest of which did not contribute anything to the principal and thus resulted in negative amortization.\footnote{Id.}

Balloon payments coupled with prepayment penalties also hurt consumers who perhaps had counted on refinancing in an ever-upward climbing real estate market, only to find themselves locked into loans with unfavorable terms when the real estate market collapsed. The dangers of these types of financing arrangements were particularly difficult for consumers to absorb, even with the benefit of TILA disclosures.\footnote{Id.}

Consumers who are seeking to borrow relatively large sums

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\footnote{Id.}
\footnote{Jeff Sovern, Preventing Future Economic Crises Through Consumer Protection Law or How the Truth In Lending Act Failed the Subprime Borrowers, 71 OHIO ST. L.J. 761 (2010).}
\footnote{Lauren E. Willis, Decisionmaking and the Limits of Disclosure: the Problem of Predatory Lending: Price, 65 MD. L. REV. 707, 768 (2006).}
of money to purchase a home may be subject to certain psychological pressures that make it difficult to absorb the relevant information presented to them via government-mandated disclosures. As the credit-products have become more complicated, so by necessity have the disclosures. And with more information being presented, consumers are more likely to experience information overload. In this situation, many people will seek to reduce the number of variables they consider to those that are most salient, such as the amount of the monthly payment in the near term, and ignore the amount of the monthly payment and other variables that arise only in the long term. The stress of the mortgage loan decision may also lead consumers to mistakenly make quick decisions to escape the stressful situation, rather than spend extra time and effort to understand the parameters of the transaction being presented. Also, the further along in the process the consumer is before they see the required disclosures, the less likely they are to abandon even a very risky and expensive home loan, due to the “endowment effect,” whereby consumers tend to overvalue something that they already consider theirs, such as their new home. Thus, even with early TILA disclosures, consumers may not be willing to provide adequate weight to the full TILA disclosures that they are given shortly before closing.

Subprime borrowers, in particular, may come into the lending market feeling relatively insecure and “ego-threatened” because their ability to secure an affordable loan may be viewed as quite uncertain. Race and gender may also play a role in the borrower’s feelings of stress and insecurity, which may divert their attention away from trying to determine whether the terms being offered are favorable to them. People who feel they are in a position of weakness relative to the seller are less likely to focus on the facts of the transaction. Such consumers may also be overly trusting and rely on the mortgage broker to make a determination for them. Many people rely too heavily on what a perceived expert such as a lender or broker may say, even when a mandatory disclosure contradicts what the perceived expert is saying. And they may also wish to have an expert actually make the decision for them, rather than use the available information to make their own decision, because many people are

38 Id.
39 Id. at 769.
41 Id. at 772-776.
simply averse to making decisions.\textsuperscript{42} Unfortunately, under the previously prevailing form of mortgage broker compensation, such as yield spread premiums, such brokers had a built-in conflict of interest and an incentive to steer their clients toward transactions that were more expensive and less favorable to them in the long run. Indeed, the mere fact that a willing lender was presented to the vulnerable consumers may have led them to ignore the unappetizing costs and terms in the disclosures.\textsuperscript{43}

Also, in loans that have large payment increases built in, consumers tend to underestimate or ignore such future costs while placing more emphasis on short-term costs such as a low down payment or relatively low monthly payments for the first period of the loan.\textsuperscript{44} Payment increases may come in the form of a switch from an introductory fixed rate to a (usually) higher adjustable rate, or in the form of a balloon payment. Borrowers are said to be myopic about long-term costs, focusing solely on the lower short-term payments.\textsuperscript{45} In addition, borrowers may assume that if their payments go up after the introductory rate ends or because of a scheduled balloon payment, that they will be able to readily refinance the mortgage and avoid these increased costs. However, the increasingly common presence of prepayment penalties in subprime mortgage loans meant that quite often the borrower would be trapped in the higher cost loan. Again, consumers who are focused on the present have difficulty factoring in information about the costs and consequences of events like prepayment penalties that may or may not come about. In addition, many consumers are overly optimistic about the future, and may wrongly assume that their income will go up just like they assume real estate prices will go up. Many consumers do not and cannot envision themselves incurring prepayment penalties or defaulting, so they do not consider these costs when taking out a loan initially, even if they are clearly disclosed. They only realize the significance of such terms much later, usually when it is too late to avoid them.

Another aspect of the increasing complexity of consumer credit disclosures is the number and variety of fees imposed by creditors, and the fact that such fees may not be included in the disclosed APR and finance charge. Exceptions from the finance charge definition for broker compensation, credit insurance, credit

\textsuperscript{42} Shahar & Schneider, \textit{supra} note 31, at 725-729.

\textsuperscript{43} Stark & Choplin, \textit{supra} note 40, at 17-18.


\textsuperscript{45} \textit{Id.} at 1120.
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reports, appraisals, etc. have undermined the usefulness of the single APR credit price tag. Some scholars have advocated for a reform of the definition of APR and finance charge to be more inclusive so that these disclosures could fulfill their original role of providing a clear and uniform price tag for the cost of credit. A 2007 Federal Trade Commission mortgage disclosure study had also advocated improved disclosures as the way to increase consumer use of credit disclosures. While this would certainly be an improvement over the present situation, merely enhancing the value of the APR disclosure and the understandability of other credit disclosures is not sufficient to protect consumers in the current mortgage market.

The improvement of consumer credit disclosures is also part of the mission of the Consumer Financial Protection Bureau (“CFPB”), the brainchild of Elizabeth Warren, a Harvard professor and consumer advocate. Professor Warren pointed out that credit products, such as subprime mortgages, can be unsafe for consumers who do not understand what they are getting into, and yet such products were not regulated as effectively as other types of consumer products, such as toasters or lawnmowers. Consumer credit was regulated by a variety of bank regulators whose mission was to protect the safety and soundness of the financial institutions they oversaw and not the consumer. By creating the CFPB, whose primary mission would be to protect consumers with regard to financial matters, consumers could be better protected by a non-captive government agency and the repeat of the subprime mortgage crisis could perhaps be prevented. This new consumer protection agency will promulgate regulations implementing the substantive requirements for residential mortgage loans, as discussed herein. However, the agency has also announced new efforts to simplify

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47 *Id.*; see also Bar-Gill, supra note 44, at 1073.
48 LACKO & PAPPALARDO, supra note 32 at ES-11 to ES-12.
51 The Federal Trade Commission historically also played a role in the enforcement of consumer credit regulation, but the Federal Reserve Board had been charged with the main responsibility for writing the regulations in this area. See PRIDGEN & ALDERMAN, *CONSUMER CREDIT*, supra note 1, § 15:2.
mortgage disclosures to improve their readability and usefulness.\textsuperscript{52} The CFPB will combine the now separate early mortgage disclosures under TILA and the Real Estate Settlement Procedures Act ("RESPA") into one more readable and easy to understand disclosure.\textsuperscript{53} Thus many regulators have attempted and continue to attempt to improve consumer credit disclosures.

Others have advocated for increased financial literacy to help consumers overcome the cognitive and emotional barriers they may be facing when confronted with financial credit cost disclosures. For instance, in 2003 Congress established the Financial Literacy and Education Commission to "improve the financial literacy and education of persons in the United States through development of a national strategy to promote financial literacy and education."\textsuperscript{54} Typically, the consumer credit industry has favored this approach.\textsuperscript{55} The argument is that well-educated and informed consumers can rationally overcome the cognitive barriers to using financial information, and could protect themselves in a competitive credit market without the need to curb any particular credit products or practices. The financial literacy approach harkens back to the original concept of TILA to simply arm consumers with comparative cost information, ideally in a form they can understand, and then government can sit back and let the free market do its work. However, the evidence that such education works to improve consumer decisions in the financial sector has been questioned by scholars, most notably Professor Lauren Willis.\textsuperscript{56} As noted above, the sheer volume and complexity of the information needed to understand and wisely choose among today’s consumer credit options is well above the average consumer’s cognitive abilities, and no amount of education, short of one-on-one counseling for each and every transaction, would be adequate to protect consumers in many cases.

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\item \textsuperscript{53} Dodd-Frank Act, Pub. Law 111-203, Sections 1032(f), 1098, 1100A (2010) (to be codified at 12 U.S.C. § 5532(f)). These regulations are to be promulgated by July 21, 2012.
\item \textsuperscript{54} 20 U.S.C. § 9702 (July 21, 2010), now supplemented by the CFPB’s Office of Financial Education, with the Director of CFPB serving as Vice Chairman of the Financial Literacy Commission, Dodd-Frank Act, Pub. Law 111-203, § 1013(d) (2010).
\item \textsuperscript{55} See generally Lauren E. Willis, Against Financial-Literacy Education, 94 IOWA L. REV. 197 (2008).
\item \textsuperscript{56} Id.
\end{itemize}
situations they face today. It is as unrealistic to think that average consumers can educate themselves to the extent necessary to make sound credit decisions using mandated disclosures alone, especially in the mortgage market, as it is to assume that consumers can all be their own lawyers, doctors or automobile mechanics. Sometimes disclosure is simply not enough to protect consumers from exploitation. Sometimes substantive regulation of products and contract terms offered in the marketplace is the only effective solution.

III. SUBSTANTIVE REGULATION OF RESIDENTIAL MORTGAGE LOANS IN THE MORTGAGE REFORM AND ANTI-PREDATORY LENDING ACT OF 2010

Perhaps in response to the criticism of the disclosure approach, Congress passed some sweeping substantive requirements with regard to residential mortgage loans in the Mortgage Reform and Anti-Predatory Lending Act of 2010 (hereinafter “Mortgage Reform Act”), which is one title of the comprehensive Dodd-Frank Wall Street Reform and Consumer Protection Act. With these new requirements in place, consumer protection in the residential mortgage area will turn away from almost exclusive reliance on consumer disclosure and consumer self-protection, and will look to substantive reform as the preferred method of protection. The impressive array of new substantive reforms contained in this new law are coming down the pike soon and mark a major shift in the approach to consumer credit regulation. The main areas of substantive reform include:

- Universal requirement of consumer “ability to repay” as a condition for all residential mortgages;
- Creation of a “safe harbor” for creditors who offer “qualified mortgages” that have certain characteristics that are favorable to

57 Pub. Law No. 111-203, 124 Stat. 1376 (2010); see generally PRIDGEN & ALDERMAN, CONSUMER CREDIT, supra note 1, §9a; see also Susan Block-Lieb & Edward J. Janger, Reforming Regulation in the Markets for Home Loans, 38 FORDHAM URB. L.J. 681 (2011) for an overview of the Act and its legislative history.
58 The effective date of most of the provisions of the Mortgage Reform Act is determined by the date when implementing regulations go into effect or by January 21, 2013 if no regulations are issued by that date. 15 U.S.C. § 1639b(b)(2).
consumers; \(^\text{60}\)
- Ban on mortgage brokers steering consumers into unfavorable loans and accepting yield spread premiums as compensation; \(^\text{61}\)
- Strict limits on prepayment penalties; \(^\text{62}\)
- Ban on “single premium” credit insurance; \(^\text{63}\)
- The prohibition on pre-dispute mandatory arbitration clauses in most dwelling-secured consumer loans; \(^\text{64}\)
- The imposition of “appraisal independence requirements” in all consumer credit transactions secured by the principal dwelling of the consumer. \(^\text{65}\)

In addition, the Mortgage Reform Act enhances the impact of pre-existing substantive and disclosure regulations regarding certain high-cost mortgage loans under the Home Ownership and Equity Protection Act (“HOEPA”) of 1994 because it broadens the scope of HOEPA to cover many more subprime residential loans. \(^\text{66}\) Each of these aspects of the increasing use of substantive regulation in the residential mortgage market under TILA will be discussed below.

The Mortgage Reform Act includes a requirement that all creditors who offer residential mortgage loans must verify that the borrower has a reasonable ability to repay. \(^\text{67}\) This major reform is included in the Mortgage Reform Act because of the perverse incentives that had existed during the build-up to the subprime mortgage crisis. When banks or other lenders dealt directly with borrowers, and kept their loans in-house, they had a built-in incentive to verify that the person asking to borrow money would be able to repay. However, with the rise of mortgage brokers working on commission and lenders reselling mortgages to distant investors, consumers were often encouraged to take out loans based more on the value of the collateral than on their income. \(^\text{68}\) Brokers could

\(^{60}\) 15 U.S.C. §1639c(b).
\(^{61}\) 15 U.S.C. §1639b(c)(1). This prohibition on YSP was foreshadowed by a Federal Reserve Board regulation that contained a very similar provision. 12 C.F.R. § 226.36(d) (2011).
\(^{64}\) 15 U.S.C. §1639e(c)(1).
\(^{65}\) 15 U.S.C. §1639e.
\(^{67}\) 15 U.S.C. § 1639c(a).
collect their fees and lenders could make their profits by passing on risky loans to others, while consumers made the gamble that they would indeed be able to make their monthly payments. As discussed above, for loans that had built-in payment hikes, adjustable rates, negative amortization, or balloon payments, the disclosures did not sufficiently deter consumers from taking on more risk than was realistic given their income and resources because of their inherent tendency to focus on the near-term payments and downplay the long-term costs and risks. To address this failure of the disclosure regime, the Mortgage Reform Act puts the responsibility on the creditor to refrain from making loans that the consumer is not likely to be able to repay.

The Mortgage Reform Act also contains a provision that attempts to encourage the use of mortgage loan contracts that include more favorable provisions for consumers without actually rewriting all contracts by law. The previously mentioned requirement that lenders verify that borrowers have a reasonable ability to repay the loan could potentially be a burden on lenders considering the increased documentation that may be entailed. As an alternative to complying with that section, however, the Mortgage Reform Act holds out a safe haven for lenders who are willing to offer a so-called “qualified mortgage” that must have certain pro-consumer characteristics. These loans must have the following provisions to avail themselves of qualified mortgage status:

- No negative amortization;
- No interest only loans;
- No balloon payments;
- Consumer’s income and financial resources are documented;
- Rates are fully amortizing;
- Creditor complies with regulations and guidelines about debt-to-income ratios;
- Total points and fees are not more than 3% of the total loan amount;
- The term of the loan is not greater than 30 years.

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69 Id.
70 See Bar-Gill, supra note 44, at 1119.
72 15 U.S.C. § 1639c(b). This section provides a rebuttable presumption that the creditor has met the “ability to repay” requirements of 15 U.S.C. § 1639c(a)(1).
73 Id.
Whether creditors will start issuing residential mortgage loans that contain this array of pro-consumer provisions remains to be seen. In any event, this will be a fascinating experiment to see whether an industry can be “nudged” to produce more consumer-friendly contracts if not required to do so.\footnote{Cf. \textit{Richard H. Thaler \& Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth and Happiness} (2008).}

For several years prior to the passage of the Mortgage Reform Act, there had been a regulatory struggle between the Federal Reserve Board, the agency that issued regulations under TILA prior to the creation of the Consumer Financial Protection Bureau, and the Department of Housing and Urban Development, the agency that implements RESPA regarding a ban on both steering and the use of yield spread premiums as broker compensation.\footnote{12 U.S.C. §§ 2601 to 2616.} A yield spread premium (“YSP”) is a form of mortgage broker compensation whereby the broker is paid by the lender for the loan yield amount that is higher than what would have been brought in by the lowest rate the lender would have been willing to accept for that particular transaction.\footnote{Schuetz v. Banc One Mortgage Corp., 292 F.3d 1004, 1007-1008 (9th Cir. 2002), cert. denied 537 U.S. 1171 (2003).} This type of compensation incentivized brokers to convince borrowers to take out higher cost loans in order to increase their own level of compensation.\footnote{Elliott Klayman, \textit{Yield Spread Premiums, Illegal Referrals, and the Real Estate Settlement Procedures Act: Blurred Vision}, 32 \textit{Real Est. L. J.} 222 (2003).} A disclosure of the YSP was contained in a RESPA-related disclosure form called the Good Faith Estimate.\footnote{24 C.F.R. § 3500.7 (2011).} But the RESPA disclosure was somewhat oblique in that it did not highlight that consumers were paying their broker compensation in the form of higher rates on their loan.\footnote{Howell E. Jackson \& Laurie Burlingame, \textit{Kickbacks or Compensation: The Case of Yield Spread Premiums}, 12 \textit{Stan. J. L. & Fin. Pol’y Rev.} 289, 305-308 (2007).} The YSP compensation was also disclosed as part of the APR and finance charge of a residential mortgage loan because this type of broker compensation became part of the financing cost of the loan.\footnote{12 C.F.R. § 226.18(d) \& (e).}

Thus, under prior law, consumers were told the actual cost of their loan, but not in a way that allowed them to understand that their loan cost them more because they were compensating their mortgage broker in the form of a higher interest rate.\footnote{See supra text accompanying notes 77-79.}
to YSP compensation also did not showcase the fact that consumers may have qualified for a less expensive loan if they were willing to pay their broker fees upfront rather than through financing. The Federal Reserve Board, meanwhile, had proposed an amendment to TILA’s Regulation Z that would have prohibited YSP compensation, rather than attempt any further improvements on the disclosure. The substantive approach of simply eliminating this unfair and, for many consumers, unintelligible form of broker compensation will be implemented under the Mortgage Reform Act.

Related to the ban on YSP compensation is the ban on steering consumers toward unfavorable mortgage loans. Prior to the subprime mortgage and foreclosure crisis, brokers were accused of steering consumers away from loans with more favorable rates, due to their incentive to earn higher YSP compensation, and steering them toward mortgages that consumers lacked the ability to repay, or loans that had predatory characteristics such as equity stripping, excessive fees, and abusive terms, and mortgages that were based on inaccurate documentation regarding the consumer’s credit record and the appraisal value of the property to be purchased. The provision in the Mortgage Reform Act will help stop the practice of steering consumers toward more expensive, subprime loans when they would actually qualify for more favorable conventional loans by banning such behavior, rather than trying to cure such practices through improved disclosures.

Consumers also had difficulty understanding and avoiding

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84 12 C.F.R. § 226.36(d) (2011). This was to have gone into effect in April 2011, but was superseded by the Mortgage Reform Act.

85 15 U.S.C. § 1639b(c)(1). Note that even under the new law, a mortgage originator will be able to receive a fee from a creditor if the mortgage originator did not receive any direct compensation from the consumer, and the consumer did not pay any upfront points or fees. 15 U.S.C. § 1639b(c)(2)(B). Also, consumers will still be able to finance origination fees or costs so long as these fees do not vary based on the terms of the loan (other than the principal amount). 15 U.S.C. 1639b(c)(4)(C).

86 15 U.S.C. 1639b(c)(3). The CFPB is mandated to promulgate regulations to implement this ban on steering.

prepayment penalties based on disclosure alone. Prepayment penalties are monetary amounts charged to the borrower for repaying the loan in the first few years, typically through refinancing. The penalties are meant to help lenders recoup the revenues they would lose in the long term should the loan be paid off early, while locking borrowers into high-cost loans that will be profitable to the lender over the long term. This penalty is particularly difficult to address through advance disclosure alone because it is a deferred cost that may not arise, and if it does, its impact is something that will take effect in future years. Behavioral economists have stated that consumers often underestimate future costs, and so the overall cost of a particular loan may appear cheaper to a consumer than it really is.

In the Mortgage Reform Act, prepayment penalties will be prohibited for residential mortgage loans that are not qualified mortgages, adjustable rate mortgages, and mortgages that have an APR that exceeds the average prime offer rate for a comparable transaction by 2.5 percentage points for first lien loans or by 3.5 percent for subordinate liens. Even for those mortgages that come under the “qualified mortgage” safe haven, prepayment penalties must be limited to no more than 3 percent of the outstanding loan balance during the first year, no more than 2 percent of the loan balance during the second year, and no more than 1 percent of the loan balance during the third year; no prepayment penalty is allowed at all after the third year. Additionally, when creditors offer a consumer a loan with a prepayment penalty, they must also offer the consumer an alternative loan that does not have a prepayment penalty.

The Mortgage Reform Act also imposes a ban on financing of “single premium” credit life, credit disability, credit unemployment, credit property insurance, accident, loss-of-income, life insurance, health insurance, and debt cancellation, or suspension agreements for all loans secured by a dwelling, both open and closed end. Credit life and other forms of credit insurance have long been criticized by consumer advocates as benefitting creditors (who are literally the beneficiaries of such insurance policies) more than they benefit

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88 Bar-Gill, supra note 44, at 1120.
89 Id. at 101-02.
90 Singer, Zachary & Simon, supra note 68, at 2.
91 Bar-Gill, supra note 44, at 1119-1121.
92 See supra text accompanying notes 73-74.
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consumers. Nonetheless, under TILA, such insurance did not have to be included as part of the finance charge as long as it was disclosed as voluntary, the premium for the initial term was disclosed, and the consumer signed or initialed an affirmative written request for the insurance after receiving the specified disclosures. A particularly egregious practice was the financing of “single premium” credit insurance, which has the effect of imposing large upfront premiums on consumers that become part of their overall debt, but from which they do not benefit if they pay off the loan early. With “single premium” insurance, the consumer pays for the insurance for the whole term of the loan at the outset, and the premium is then included in the amount financed. The Mortgage Reform Act bans this practice, although insurance premiums calculated and paid on a monthly basis are still permitted. Again, a ban is necessary because disclosure alone would not have effectively helped consumers make a rational choice regarding this particularly obscure type of financing due to consumers’ cognitive barriers to processing long-term costs.

Another bright spot for consumers in the Mortgage Reform Act is its ban on pre-dispute arbitration clauses in all dwelling-secured closed-end consumer loans, and all open-end consumer loans secured by the consumer’s principal dwelling. Such arbitration clauses in consumer contracts deprive the consumer of the right to go to court to protect their rights even under specific consumer protection statutes (such as TILA) that grant a private cause of action and a possible award of attorney’s fees. Many scholars and consumer advocates have argued against the enforcement of such clauses on the basis that consumers do not get fair treatment in arbitration forums where the judges are paid by repeat players like the creditors. Arbitration requires the parties to pay the cost of the proceedings, their own attorney fees, and other litigation costs; they

101 Bar-Gill, supra note 44, at 1119-1121.
also give up the right to a jury trial, an appeal, and possibly class actions.105 Given that the United States Supreme Court has had a long history of favoring the enforcement of arbitration clauses in consumer contracts by virtue of a strict adherence to the Federal Arbitration Act,106 countervailing legislation by Congress appears to be the only way to relieve consumers of this type of clause. Disclosure of the fact that disputes will be subject to arbitration has proven unhelpful because these clauses appear in standard form contracts that are seldom read and never negotiated, and the possibility of having a dispute go to arbitration rather than to court is a fact that is a long range possibility, not something that consumers typically focus on in making a mortgage loan decision.107 Thus, once again, the Mortgage Reform Act substantively prohibits this type of clause in dwelling-secured loans, rather than relying on disclosure alone.108

Finally, the Mortgage Reform Act imposes “appraisal independence requirements” in all consumer credit transactions secured by the principal dwelling of the consumer.109 In the period before the subprime mortgage crisis, it was alleged that mortgage brokers sometimes coerced appraisers to artificially inflate the value of the home being purchased on credit, which led to consumers taking on more debt than necessary, and paying too much for their homes.110 Such inflated appraisals also had the effect of enhancing the broker’s commission if based on the sale price of the home.111 TILA, as amended by the Mortgage Reform Act, now imposes “appraisal independence requirements” in all consumer credit transactions secured by the principal dwelling of the consumer. Violations of these requirements include:

- Coercion of an appraiser to attempt to cause that person to base

105 See generally Alderman, supra note 104, at 1237.
106 See, e.g., AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1744 (2011), applying the FAA, 9 U.S.C. § 2, to a cellular telephone contract that contained a mandatory arbitration clause and a waiver of class arbitration.
107 See Bar-Gill, supra note 44, at 1119-1121.
108 The CFPB has been charged with studying mandatory pre-dispute arbitration clauses for all consumer credit contracts, not just mortgages, and would have the authority to issue a regulation banning or limiting such clauses. 12 U.S.C. § 5518. There is no set deadline for this action, however.
111 Id.
the value assigned to the property on any factor other than the appraiser’s independent judgment;
• Mischaracterization of value, including misrepresentation, falsification or alteration;
• Withholding or threatening to withhold timely payment in order to influence an appraisal;
• Appraiser may not have a direct or indirect interest in the property being appraised.112

Creditors who are aware of such violations may not extend credit without documentation of reasonable diligence regarding the property valuation.113 Violations of these requirements may result in civil penalties of up to $10,000 for each day the violation continues, in addition to the normal TILA civil liability.114

Mortgage servicers are also subject to other requirements under the Mortgage Reform Act, including many disclosure provisions but also some substantive ones such as restrictions on escrow accounts and “force-place” insurance.115 Thus, the Mortgage Reform Act has taken a rather aggressive approach to these types of issues in mortgage servicing.116

IV. THE PROS AND CONS OF PUTTING MORE “TEETH” INTO CONSUMER CREDIT REGULATION

The substantive provisions of the Mortgage Reform Act outlined above are part of a trend in consumer credit regulation. For instance, the 2009 Credit CARD Act, a law that overhauled TILA’s provisions regarding unsecured open-end credit plans (i.e., credit cards),117 contained many substantive provisions as well as improved disclosures. These substantive provisions include limits on the timing

of increases in interest rates, a ban on “two-cycle” billing, limits on the availability of credit cards to youthful consumers under the age of twenty-one, and limits on certain types of fees and billing practices. As with mortgage reform, lawmakers were cognizant of the limited ability of disclosure regulation to protect consumers, and thus provided more substantive protection.

The question raised by this trend toward more substantive regulation is whether the benefits of this regulatory shift outweigh the costs. Some of the arguments raised by critics of federal substantive consumer credit regulations include: fears that such a trend will shrink the availability of consumer credit; that the costs imposed on the credit industry will increase the cost of credit for consumers; that there will be unforeseen and unintended adverse effects; and that such substantive regulation unduly interferes with individual choice and free market forces. Federal regulation in the consumer credit area, even disclosure regulation alone, has long been criticized for imposing too heavy a burden on industry. While it is true that all regulation imposes costs, it is also true that all unchecked market exploitation of consumers imposes costs as well. It remains to be seen how the costs of the new substantive regulations of the Mortgage Reform Act will affect the cost of consumer home-secured credit, but in the long history of federal consumer credit regulation, regulation has not produced a shrunken credit market.

Even the most well-intended substantive regulations can have inadvertent side-effects. For instance, the ban on credit card issuance to consumers under the age of twenty one in the absence of a co-signer who is at least twenty-one may have had the unintended effect of encouraging fellow students who are just at or near twenty one, and are themselves unaware of the dangers of co-signing any type of credit transaction, to co-sign for credit cards, as opposed to

126 Erica Sandberg, 3 Reasons Not to Co-sign for College Students’ Credit Cards, CREDITCARDS.COM (July 30, 2010), http://www.creditcards.com/credit-
the intended co-signers: parents and guardians. A cap on fees for one type of transaction, such as the cap on debit card processing fees that can be charged by banks to retailers contained in the Dodd-Frank Act, may simply result in the increase of other fees as banks seek to make up their lost revenues in other ways. At this point, when most of the substantive provisions of the Mortgage Reform Act have not yet been implemented, it is impossible to predict what unintended side-effects may develop, but past experience shows that it is difficult to write any law that does not entail such effects.

Another criticism of the substantive approach is that outlawing specific practices, or requiring others, necessarily is a reactive process, in which the substantive requirements are in reaction to perceived past abuses of consumers. The regulation of specific practices in turn may spawn industry reaction, and the result will be the creation of new practices that are outside the boundaries of specific regulations, but that may have similar bad effects. In other words, specific substantive regulation always risks the discovery and exploitation of overlooked loopholes or unforeseen developments that skirt the intent of the law. For instance, when Congress passed a restriction on “wrongful disclosure of video tape rental or sale records” to protect consumers’ privacy regarding the titles they rented from a “video tape service provider,” they may not have foreseen the development of DVDs and online streaming. Thus, it may well be that the new substantive regulations in the Mortgage Reform Act, such as those mentioned above, will soon be outmoded as market participants find other ways to structure their transactions so as to maximize profits while not necessarily providing consumers with the full level of protection intended by the law.

The marketplace and technology have a way of outpacing

\[\text{card-news/sandberg-3-reasons-not-cosign-fellow-college-students-1377.php; } \text{THE CREDITEER, College Students, Credit Cards and the Co-Signer (May 2, 2010),}\]
\[\text{http://thecrediteer.com/2011/05/college-students-credit-cards-and-the-co-signer/}.\]

\[\text{Note that the Federal Trade Commission has a regulation requiring disclosure to co-signers for the very reason that many consumers do not understand their obligations when they co-sign a loan. 16 C.F.R. § 444.3.}\]

\[\text{128 15 U.S.C. § 1693o-2(a), mandating regulations to set reasonable fees for interchange transaction fees for debit card transactions.}\]

\[\text{129 See Bank Accounts: More Fees Are Coming. How to Fight Back -- or Flee, CONSUMER REPORTS, Feb. 2012,}\]
\[\text{http://www.consumerreports.org/cro/magazine/2012/02/bank-accounts/index.htm.}\]

\[\text{130 Max Huffman, Presentation at the Loyola Consumer Law Review Symposium on The Continuing Effects of the Mortgage Crisis on Consumers (Feb. 24, 2012).}\]

\[\text{131 18 U.S.C. § 2710.}\]
regulations of all types, both disclosure and substantive. Even within the disclosure regime, the TILA disclosures have had to grow in length and complexity to keep up with new credit products that include multiple APRs and fees.\(^{132}\) And yet, even with the move toward more substantive federal credit regulation, disclosure will continue to play an important role in protecting consumers. The CFPB is working on the daunting task of developing an integrated, shortened, and more accessible disclosure form for home mortgages that will combine the requirements of both TILA and RESPA.\(^ {133}\) Recognizing that the work of improving the comprehension of consumer disclosures is never really done, the CFPB conducted seven rounds of consumer testing and has processed 27,000 comments on the proposed combined home mortgage cost disclosure.\(^ {134}\) Improving disclosures is a necessary complement to the substantive regulations on mortgages mentioned above. While disclosures alone may not be able to spur consumers to rational decision-making, they are still necessary and should be made as useable as possible.

While there appears to be a move toward substantive regulation of consumer credit, as embodied in the Mortgage Reform Act of 2010, the trend has taken the form of measured, targeted regulation based on documented abuses. Thus, the Mortgage Reform Act consists of a specific set of reforms that hopefully will help consumers avoid exploitation but still leaves room for freedom of choice by well-informed consumers. No one is advocating a return to the old usury law approach to consumer credit, which is the ultimate form of substantive consumer credit regulation. Usury laws for residential mortgages were abandoned in the 1980s under heavy criticism of undue interference and distortion of consumer credit market prices.\(^ {135}\) But specific targeted measures, such as requiring that consumers have an ability to repay their loans; requiring that

\(^{132}\) See supra text accompanying footnotes 25-29, regarding the need for new disclosure regulations with the appearance of ARMs and HELOCs in the mortgage market.


\(^{135}\) In 1980, Congress enacted the Depository Institutions Deregulation and Monetary Control Act, Pub. L. No. 96-221, 94 Stat. 132 (codified in various sections of titles 12 and 15 of the U.S. Code), which largely did away with state usury laws covering loans for residential real property secured by first mortgages.
appraisers act independently from brokers; eliminating confusing and potentially unfair forms of mortgage broker compensation such as yield spread premiums; limiting unexpected traps such as prepayment penalties; and banning pre-dispute mandatory arbitration clauses, will likely provide much needed fairness in the home mortgage market.

V. CONCLUSION

The “teeth” in the new TILA provisions represented by the Mortgage Reform Act of 2010 are a very necessary departure from an over-reliance on disclosures that are not being used, and toward a more balanced approach to consumer protection. While this may seem to move federal credit law away from its founding philosophy of providing consumers with uniform credit cost information so that they can make rational decisions in the marketplace, the over 40-year quest to perfect the disclosure regime has perhaps reached its limits. Disclosures alone were struggling to keep up with the array of credit products being offered to consumers, despite many worthwhile attempts to improve the disclosures to make them more user-friendly. In addition, the teachings of behavioral economics have now demonstrated that consumers labor under certain cognitive and social barriers that may prevent them from making the best use of the information offered. Recent Congressional legislation, such as the Credit CARD Act and the Mortgage Reform Act, demonstrate how some targeted substantive provisions can be used to supplement the use of disclosures. This new willingness of lawmakers to respond to the needs of consumers is a step in the right direction.