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ARTICLE

RETHINKING DISCLOSURE IN A WORLD OF RISK-BASED PRICING

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The residential mortgage market in the United States has changed significantly since the passage of current federal mortgage disclosure laws in the 1960s and 1970s. In this Article, Professor Patricia McCoy advocates for the reform of these traditional disclosure rules. After describing the evolution of the subprime mortgage market and providing a description of current federal disclosure laws, she explores how these new market dynamics cause the traditional disclosure rules to break down in the subprime market. Professor McCoy concludes with proposals to counteract false advertising practices, facilitate meaningful comparison-shopping, and formulate streamlined disclosures addressing loan applicants' greatest concerns in the subprime market.

In recent years, the mortgage debt of ordinary homeowners has mounted, garnering widespread attention and concern. Policymakers exhort consumers to minimize their cost of credit by comparison-shopping for home mortgages. But calls for comparison-shopping ignore the fact that certain consumers—specifically, individuals with poor credit—face informational barriers that make meaningful comparison-shopping for mortgages nearly impossible. In view of these barriers, it is not at all surprising, as a leading scholar noted fifteen years ago, that shopping for credit "remains extremely limited—limited to the same upscale consumers who would manage perfectly well without benefit of legislation."

The system of mandatory mortgage disclosures in the United States was designed for the old world of prime loans. The Truth in Lending Act and the Real Estate Settlement Procedures Act were both enacted to remove informational barriers to consumer search for residential mortgages. These

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Statutes were written when the sole conventional mortgage market was the prime market and access to home mortgages was limited to customers with strong credit.

Since then, the U.S. residential mortgage market has undergone rapid change. The market has evolved from strictly a prime market based on average-cost pricing (in which comparable mortgages have roughly one price) to a dual market offering both prime loans and subprime loans featuring risk-based pricing (in which the price for a given mortgage varies according to the borrower's risk).

However well traditional mortgage disclosure rules work in prime market conditions, these rules break down in the subprime world of risk-based pricing. Numerous subprime advertisements are tantamount to affirmative misrepresentations for most customers with blemished credit because lenders generally tout only their best rates. Subprime lenders do not provide firm price quotes to customers before application and often not until closing, when it is too late to shop. Similarly, lock-in commitments, which are customary in the prime market, are rarely ever seen in the subprime world.

If comparison-shopping means anything, it means the ability to obtain firm apples-to-apples price quotes from multiple lenders without having to pay large, nonrefundable fees. Unfortunately, most subprime customers lack that ability. Instead, under current federal disclosure laws, subprime lenders can entice customers with rosy prices that are not available to weaker borrowers, hike the price after customers pay a hefty application fee, then raise the price again at closing, often with no advance notice. Under these circumstances, our broken system of federal mortgage disclosures impedes meaningful comparison-shopping and efficient subprime prices.

This state of affairs is not inevitable. Subprime lenders and mortgage brokers have the technology and information they need right now to provide firm price quotes to consumers at minimal cost without extracting large application fees. Requiring lenders and brokers to use this technology to provide firm quotes would revolutionize consumer search in the subprime world. Similarly, minor changes to federal regulations governing subprime mortgage advertising could help alleviate the current state of rampant misrepresentations and misleading omissions in the subprime market. Advance disclosure of legitimate changes in loan terms at least a

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4 A lock-in commitment is “a lender’s promise to hold a certain interest rate and a certain number of points for [a loan applicant], usually for a specified period of time, while [the applicant’s] loan application is processed.” BD. OF GOVERNORS OF THE FED. RESERVE SYS., A CONSUMER’S GUIDE TO MORTGAGE LOCK-INS 2 (2005), available at http://www.federalreserve.gov/pubs/lockins/default.htm.
week before closing would further constrain bait-and-switch tactics. Finally, revamped disclosure rules for variable-rate\(^5\) loans would help consumers understand their worst case payment scenario, which is the biggest risk presented by these loans.

This Article proceeds as follows: Part I describes how the residential mortgage market has evolved from a prime market based on average-cost pricing to a dual market that also uses risk-based pricing. Part II provides a thumbnail description of the relevant provisions of federal mortgage disclosure law. Part III explains why the market dynamics of the subprime market cause the traditional disclosure rules to break down. Part IV sets forth this Article’s proposals for reforming the disclosure rules to permit meaningful comparison-shopping in the subprime market.

I. THE OLD WORLD AND THE NEW

In the 1960s and 1970s, when current federal mortgage disclosure laws were enacted, the mortgage world was a different place. Individuals with poor credit were systematically excluded from conventional credit, lenders gave free price quotes, lock-in commitments were common, and mortgages with comparable features went for approximately the same price. Congress designed federal disclosure laws with these market conditions in mind. In subsequent decades, when market conditions evolved and credit became available to weaker borrowers at higher, risk-adjusted prices, the disclosure laws began to show their age.

A. The Old World Of Average-Cost Pricing

Before 1990, mortgage lenders generally restricted home loans to prime borrowers, who are individuals with strong credit. Lenders rationed credit because demand exceeded supply.\(^6\) People who banks categorized as risky could not get conventional home mortgages.\(^7\) Furthermore, many lenders stereotyped blacks, Hispanics, and members of other minority groups as inherently risky and categorically denied them loans.\(^8\)

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\(^6\) See Joseph E. Stiglitz & Andrew Weiss, Credit Rationing in Markets with Imperfect Information, 71 AM. ECON. REV. 393, 393–95 (1981) (providing a theoretical justification for credit rationing at market equilibrium).

\(^7\) See id.

In this market, known as the "prime market," lenders price mortgages based on average cost. Prime borrowers have narrow differences in credit risk. Lenders do not adjust the price for prime mortgages, however, based on these differences in risk. Instead, under average-cost pricing, a lender aggregates individual credit risks and computes one price for all of its prime borrowers based on the average. As a result, for any given loan product, such as a thirty-year fixed-rate mortgage with no points, a lender will charge all of its prime borrowers an identical price.\(^9\)

Under average-cost pricing, not every loan applicant will qualify for and receive a loan. Instead, average-cost pricing amounts to a pass-fail system. If the applicant qualifies, she receives the standard price. If she does not, the lender denies the loan outright.\(^10\)

Average-cost pricing has two important implications for efficient pricing. First, prices for prime mortgages with comparable features are highly competitive and trade within a relatively narrow band.\(^11\) Similar mortgages have roughly homogeneous prices. Second, this price competition gives prime borrowers leverage to demand concessions from lenders in the form of lock-in commitments, interest rate reductions in exchange for points, and the general absence of prepayment penalties.\(^12\)

**B. The New World of "Risk-Based" Pricing**

Starting in the late 1970s and continuing through the early 1990s, a confluence of legal, technological, and market forces caused the residential mortgage market in the United States to undergo wholesale transformation.\(^13\) These changes resulted in the emergence of the subprime mortgage market, which is designed for borrowers with poor credit and charges higher interest rates and fees than the prime market. The subprime market charges different borrowers different prices for the same product, ostensibly based on their individual risk.

In theory, such "risk-based pricing" pigeonholes borrowers according to risk and calibrates prices accordingly. This leads to multiple prices for the same loan. The price of the loan goes up as the borrower's credit-

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\(^10\) See id. at 17–18, 20.

\(^11\) See id.


worthiness goes down. Subprime lenders, for example, may differentiate prices according to a complex matrix of factors, including credit scores, loan-to-value ratios, debt ratios, and prepayment risk.

At this point, it is important to add a caveat: in reality, "risk-based pricing" is a misnomer. "Risk-based pricing" implies that pricing is accurately calibrated to credit risk. In reality, prices in the subprime market are only partly based on differences in borrowers' risk. Other factors, including mortgage broker compensation, discrimination, and rent-seeking can and do push up subprime prices. This phenomenon has resulted in well-publicized abuses in the subprime market. Accordingly, this Article uses the term "risk-based pricing" in its weak sense to refer to individualized pricing that may or may not be accurately tailored to a borrower's risk.

II. FEDERAL LAW GOVERNING PRICE REVELATION IN THE HOME MORTGAGE MARKETS

In thinking about whether comparison-shopping is feasible in the subprime market, it is necessary to analyze how prices are revealed to consumers. In both the prime and subprime markets, price revelation is the result of interaction between market forces and federal (as well as state) disclosure laws. Such interaction varies, often dramatically, depending on whether a consumer is shopping in the world of average-cost or risk-based pricing.

This Article focuses on federal disclosure laws governing closed-end residential mortgages (other than reverse mortgages), which are often associated with subprime lending abuses. Two major federal disclosure laws—the Truth in Lending Act ("TILA") and the Real Estate Settlement

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16 See, e.g., Lax et al., supra note 14, at 565 (finding that "some borrowers end up with subprime loans for reasons other than risk" and calling that finding "disturbing").

17 See, e.g., Engel & McCoy, supra note 13, at 1259–70, 1280–98.

18 Closed-end mortgages are loans that finance fixed amounts of principal. Open-end mortgages, in contrast, are lines of credit in which the amount financed varies between zero and a dollar limit stated in the loan contract, at the borrower's option. See generally ELIZABETH RENUART & KATHLEEN KEEST, NAT'L CONSUMER LAW CTR., TRUTH IN LENDING § 4.1.2 (5th ed. 2003 & Supps.) (discussing open-end and closed-end credit); Bd. Of Governors of the Fed. Reserve Sys., What You Should Know About Home Equity Lines of Credit, available at http://www.federalreserve.gov/pubs/equity/equityenglish.htm (comparing traditional mortgages with home equity lines of credit). Reverse mortgages are "transactions in which payments are due only upon transfer of the dwelling in which the security interest is taken or when the consumer dies or moves." RENUART & KEEST, supra, § 4.1.2.

19 15 U.S.C. §§ 1601–1693 (2000). One section of TILA, the Home Ownership and Equity Protection Act ("HOEPA"), mandates stricter disclosures for the most expensive subprime loans. For a description of HOEPA's disclosure rules, see infra notes 66–72 and
ment Procedures Act ("RESPA")—mandate disclosures about the costs associated with most residential mortgages. RESPA requires standardized disclosures about the settlement costs of residential mortgages. TILA requires lenders to disclose the cost of credit in two standardized formats: the finance charge and the annual percentage rate ("APR"). The finance charge seeks to capture the total dollar cost that a borrower will pay for credit, including interest payments, points, origination fees, and private mortgage insurance. The APR provides a different metric of the total cost of credit by converting the finance charge into an effective interest rate per year. The Federal Reserve Board promulgates regulations implementing TILA, while the Department of Housing and Urban Development ("HUD") implements RESPA.

A. Regulation of Price Revelation in General Advertising

Often, consumers shop for products by comparing prices in general advertisements. Neither TILA nor RESPA requires lenders to advertise prices. Consequently, when lenders advertise the cost of credit, they do so voluntarily.

TILA lightly regulates the content of loan advertisements, while RESPA does not regulate advertisements at all. TILA's provisions require lenders to make standardized disclosures whenever other price terms are advertised. Specifically, any advertisement that states an interest rate must state the annual percentage rate. Written advertisements may also state a simple, periodic, nominal interest rate to be applied to an unpaid balance so long as that rate is no more conspicuous than the APR. Oral responses to consumer inquiries about rates for closed-end loans, in contrast, may only state the APR. Finally, any advertisement that quotes any of four types of loan terms—a down payment by percentage or amount, the amount of any monthly loan payment or finance charge, the number accompanying text.

21 See infra Part II.B.2.
22 See infra Part II.B.1.
27 15 U.S.C. § 1665(a); see also 12 C.F.R. § 226.26(b) (creating an exception providing "that a simple annual rate or periodic rate also may be stated if it is applied to an unpaid balance"); cf. id. § 226.26(a) (governing open-end credit).
of payments, or the period of repayment—must also state the APR, the terms of repayment, and the amount or percentage of any down payment.\textsuperscript{28}

Other provisions of TILA prohibit specific types of misrepresentations or misleading omissions in advertising. Thus, lenders may not advertise specific credit terms, such as APRs or minimum down payments (such as "zero down payment" or "only 5% down") unless they actually offer those terms.\textsuperscript{29} However, neither TILA nor its regulations require sub-prime lenders to offer their best, advertised terms to every customer. Indeed, the statute and the regulations do not even require lenders to provide disclaimers stating that availability depends on creditworthiness.\textsuperscript{30}

Advertisements featuring low introductory rates on variable-rate loans—known as “teaser rates”—raise other difficulties that TILA fails to fully resolve. Under TILA, an advertisement touting a teaser rate must state how long the teaser rate lasts and advise readers that the APR could rise after consummation.\textsuperscript{31} However, nothing in TILA requires an ad to describe the rate increase, its limits, or how it would affect the payment schedule.\textsuperscript{32} This allows lenders to entice borrowers with promises of low interest without revealing how high their interest rate could eventually go.

Other aspects of TILA regulation weaken the effect of even these few restrictions on home loan advertisements. For instance, there are “no specific rules for the format of the necessary [advertising] disclosures.”\textsuperscript{33} While advertising under TILA is supposed to display information “clearly and conspicuously,”\textsuperscript{34} the spirit of that standard is often honored in the breach. In fact, the Official Staff Interpretations of TILA’s regulations advise that the “credit terms need not be printed in a certain type size nor need they appear in any particular place in the advertisement.”\textsuperscript{35} What is

\textsuperscript{28} 15 U.S.C. § 1664(d); 12 C.F.R. § 226.24(c); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.24(c); cf. 12 C.F.R. § 226.16(d) (governing open-end home equity plans).

\textsuperscript{29} 15 U.S.C. § 1662(2); 12 C.F.R. § 226.24(a); cf. id. § 226.16(a) (governing open-end credit).

\textsuperscript{30} Congress also recently amended TILA to provide that when a lender advertises a loan in which the amount lent may exceed the fair market value of a principal residence that secures the loan (either in paper format or on the Internet), the lender must clearly and conspicuously state that the interest on any principal that exceeds the home’s fair market value is not deductible for federal income tax purposes and advise consumers to consult a tax adviser. See 15 U.S.C.S. § 1664(c) (LexisNexis 2005); see also id. § 1638(a)(15), (b)(3); Truth in Lending, 70 Fed. Reg. 60,235, 60,244 (Fed. Reserve Sys., advance notice of proposed rulemaking, Oct. 17, 2005). This provision does not take effect, however, until twelve months after the date of publication of implementing regulations by the Federal Reserve Board. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, tit. XIII, § 1302(c), 119 Stat. 23, 209 (2005) (to be codified at 15 U.S.C. § 1637a note). As of November 19, 2006, no such regulations had yet been adopted.


\textsuperscript{33} Id. § 226.24.

\textsuperscript{34} 15 U.S.C. § 1632(a).

\textsuperscript{35} Id.; 12 C.F.R. § 226.17(a)(1); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp.
more, consumers cannot sue lenders or the publications that run their ads under TILA for advertising violations. As a result, enforcement of TILA's advertising rules is weak or nonexistent.

In sum, TILA's provisions on mortgage advertising are silent on two key issues that affect truth in advertising for subprime loans. First, TILA allows subprime lenders to tout their best rates, without disclaimers and regardless of the fact that numerous subprime customers will not qualify for those rates. Second, TILA permits lenders to dangle alluring teaser rates before consumers without notifying them how high their interest rates might go following rate reset. Weak enforcement of TILA's few advertising provisions further increases the likelihood of misleading disclosures.

B. Subsequent Disclosures

When consumers shop for credit, they often inquire into the terms of specific loans. For the most part, however, TILA and RESPA do not regulate disclosures in response to these consumer inquiries at or before the application stage. When a loan officer or broker takes an application, for instance, she will usually make representations to the customer about the nominal interest rate, the loan product (e.g., fixed, adjustable rate, hybrid, interest-only), and the loan term (e.g., thirty years) by entering that information on the application form (Figure 1). These entries are not binding, however, under TILA or RESPA. The lender is free, at least under these statutes, to change the loan product or the final terms of the loan for any reason after taking the loan application so long as the lender satisfies all subsequent disclosure requirements. Entries on the application form only become binding if the borrower and the lender privately negotiate a lock-in commitment, which is common in the prime market but not in the subprime market.

After a consumer submits a loan application, TILA and RESPA impose disclosure requirements. As discussed below, the content of those
disclosures and their timing vary depending on the loan product and the statute.

1. The Truth in Lending Act

a. In General

Except for variable-rate disclosures, TILA does not require disclosures about loans that elicit consumer inquiries until sometime after application. At that point, TILA requires written disclosure of the APR, the amount financed, the finance charge, and certain other features of the loan (Figure 2). The deadline for these disclosures depends on the loan type. For first-lien, closed-end purchase money mortgages (i.e., loans used to buy homes) that are governed by RESPA, the lender normally must deliver or mail good faith estimates of these TILA disclosures within three business days after receiving a written loan application. For most closed-
end refinance mortgages, however, a lender can postpone making TILA disclosures until any time “before the credit is extended,”44 which the Federal Reserve Board construes to mean any time “before consummation.”445 Thus, for most refinance mortgages, a lender can delay providing TILA disclosures until the closing, so long as the customer signs the TILA disclosures before signing the loan agreement. “Theoretically, at least, disclosures could be given one second or thirty days before consummation without violating this requirement.”446

This loophole for refinance loans hobbles borrowers in the subprime market, where refinance loans have been rife with abuses.47 Even for loans requiring disclosures within three business days after receipt of application, most borrowers do not receive TILA disclosures before paying their application fees.48 These fees usually are nonrefundable and cost several hundred dollars.49 Accordingly, unless a lender volunteers the information required by TILA before taking an application, the customer must pay several hundred dollars in order to learn the price of the loan. Even then, under TILA, many refinance customers may not learn the price of the loan until closing.

The only time lenders must provide individual disclosures under TILA before customers pay application fees is for variable-rate disclosures. When a customer is considering a closed-end variable-rate loan50 secured by her principal residence, the creditor must supply her with a generic government handbook that provides an overview of how adjustable-rate mortgages work.51 The lender must also provide the customer with copi-

determines within three days after receipt of a written application that the application will be turned down on the terms requested, no disclosures are necessary. Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.19(a)(1)-(4).

In the rare event that the borrower consummates the loan before the three-day period elapses, the lender must make the disclosures before consummation. 12 C.F.R. § 226.19(a)(1). This could occur, for example, if a lender or broker fraudulently induced a consumer to sign a loan note unknowingly before the three-day period expired.

44 15 U.S.C. § 1638(b)(1). High-cost, closed-end refinance home loans that are governed by the Home Ownership Equity and Protection Act ("HOEPA") are subject to more stringent timing requirements. See infra notes 66-72 and accompanying text.


46 Renuart & Keest, supra note 18, § 4.3.2.

47 See Engel & McCoy, supra note 13, at 1263, 1275, 1279 n.104, 1282 n.118.


49 See, e.g., Stef Donev, Getting a Mortgage: Find the Best Loan (Sept. 13, 2006), http://mortgages.interest.com/content/articles/mortgage_story.asp?story_id=1000034867&ID=interest (“Most lenders charge a non-refundable application fee that can range from less than $250 to as much as $500.”).

50 This Article uses “variable-rate” and “adjustable-rate” interchangeably.

ous generic disclosures about every variable product in which the customer expresses an interest. These disclosures, among other things, notify the customer that she has inquired about a variable-rate loan. A creditor who deals directly with the customer must furnish these disclosures whenever it provides the application form or before the customer pays a nonrefundable fee, whichever is earlier. When a creditor solicits a loan application by phone or through an intermediary agent or broker, however, it may deliver the disclosures or put them in the mail no later than three business days following receipt of the application.

While the timing rules for variable-rate disclosures represent a modest improvement over the general disclosure rules, the content of those disclosures do not. The disclosures, twelve in number, range from a generic explanation of the index and the margin to obscure disclosures about the potential payment shock once the interest rate resets. These profuse and bewildering disclosures amount to information overload (see example at Figures 3a–3c). Furthermore, some courts have construed TILA to deny statutory damages liability for failing to give the variable-rate disclosures.

Perhaps as a consequence of this case law, which discourages compliance, one major consumer advocacy organization reported that “[f]ew of our clients ever get these initial disclosures.” Later, at the closing, the final relevant TILA disclosure simply states that “[y]our loan contains a variable-rate feature. Disclosures about the variable-rate feature have been provided to you earlier” (Figure 2). Consequently, if the creditor fails to deliver the initial variable-rate disclosures, the consumer will receive no advance disclosures about the maximum payment, the maximum interest rate, or the index used.

The variable-rate disclosure of greatest importance to most consumers is the worst case payment scenario under the loan—i.e., how high their

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52 12 C.F.R. § 226.19(b) (containing disclosure rules for closed-end, variable-rate, home-secured loans with terms of over one year); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.19(b)-3. If a mortgage broker does sufficient business with the creditor, the broker no longer qualifies as an “intermediary agent or broker,” thus requiring the creditor to treat all applications solicited by that broker as applications made directly to the creditor. See id.

53 12 C.F.R. § 226.19(b).

54 Id. For discussion of when a mortgage broker qualifies as an “intermediary agent or broker” for purposes of this provision, see Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. I, § 226.19(b)-3. If a mortgage broker does sufficient business with the creditor, the broker no longer qualifies as an “intermediary agent or broker,” thus requiring the creditor to treat all applications solicited by that broker as applications made directly to the creditor. See id.

55 12 C.F.R. § 226.19(b).

56 See, e.g., Baker v. Sunny Chevrolet, 349 F.3d 862 (6th Cir. 2003); Brown v. Payday Check Advance, Inc. 202 F.3d 987 (7th Cir. 2000); see also Renuart & Keest, supra note 18, § 8.6.5.3.

57 Letter from the Nat’l Consumer Law Ctr. to Vice Chairman Roger W. Ferguson, Jr., and Governors Susan Schmidt Bies, Donald L. Kohn, and Mark W. Olson of the Fed. Reserve Bd. 2 (Jan. 17, 2006) (on file with the author).
monthly principal and interest payments could go if the loan hits its interest rate cap. Presumably consumers would like to know the actual dollar amount of their highest possible monthly payment. Instead, TILA allows lenders to provide a hypothetical involving payment shock on a $10,000 mortgage and let the borrowers do the math (Figure 3c, ¶4). Alternatively, lenders may provide a historical example, again based on a $10,000 mortgage, explaining how high the payments would have gone under the terms of that loan based on the historical high for the past fifteen years (Figure 4). Lenders cling to the $10,000 hypotheticals, which are arcane in the extreme, precisely because many consumers, particularly vulnerable ones, cannot calculate the payment shock for variable-rate mortgages. The $10,000 hypotheticals are so badly outdated that The New York Times recently advised borrowers with exotic adjustable-rate mortgages to figure out their maximum monthly payments by consulting "mortgage payment calculators on the Web"—not their TILA disclosures.

If initial disclosures, whether variable-rate or otherwise, turn out to be inaccurate, TILA sometimes requires redisclosure. If the lender denies the original application and the consumer then amends it, the amendment is treated as a new application and the three-day period starts anew. If a variable-rate feature is added to the loan, new disclosures are necessary, but only immediately before consummation. Finally, if the actual APR at closing varies from the APR that was originally disclosed by more than one-eighth of one percent, usually the creditor must disclose the actual

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58 See 12 C.F.R. § 226.19(b)(2)(viii)(B), (ix)(B) (stating that the lender may provide at its option the “maximum interest rate and payment for a $10,000 loan originated at the initial interest rate (index value plus margin, adjusted by the amount of any discount or premium) in effect as of an identified month and year for the loan program disclosure assuming the maximum periodic increases in rates and payments under the program,” along with an “explanation of how the consumer may calculate the payments for the loan amount to be borrowed based on” the $10,000 hypothetical).

59 See 12 C.F.R. § 226.19(b)(2)(viii)(A) (providing that the lender may alternatively disclose a “historical example, based on a $10,000 loan amount, illustrating how payments and the loan balance would have been affected by interest rate changes implemented according to the terms of the loan program disclosure”). Lenders must also explain how consumers can apply the historical example to calculate the maximum payment on their own loans. 12 C.F.R. § 226.19(b)(2)(ix)(A).

60 A 2004 study by the Consumer Federation of America found that over one-third of all Americans surveyed who preferred ARMs could not estimate a hypothetical payment increase. The percentages were even worse for respondents who were young adults age 18 to 24 (46%), Hispanics and blacks (43%), people with incomes under $25,000 (44%), and people without a high school degree (50%). Press Release, Consumer Fed’n of Am., Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages (July 26, 2004), available at http://www.consumerfed.org/pdfs/072604_ARM_Survey_Release.pdf. See also infra notes 127–128 and accompanying text.


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APR by the settlement or consummation. These last two rules place applicants who lack lock-in commitments at the mercy of lenders, who can change the loan terms and even the loan products behind the scenes and then spring the new loan terms on the borrowers at closing.

b. High-Cost Loans Governed by the Home Ownership and Equity Protection Act

Under the Home Ownership and Equity Protection Act ("HOEPA"), federal disclosure law imposes stricter disclosure requirements on certain high-cost residential mortgages. HOEPA applies to most high-cost, closed-end, refinance residential mortgages. HOEPA defines high-cost loans in two ways: (1) loans with APRs of at least eight percent over the yield on Treasury securities of comparable maturity for first-lien loans (or ten percent for subordinate-lien loans); or (2) loans with total points and fees exceeding eight percent of the total loan amount or $400 (indexed annually), whichever is greater.

These so-called "HOEPA loans" require added disclosures at least three days before closing. The advance disclosures include the final APR, the amount of individual monthly payments, the amount of any balloon payment, the principal borrowed, and fees for any credit insurance or debt-cancellation policy. Lenders must notify borrowers in writing that they could lose their homes upon default. Similarly, borrowers must be advised that they do not have to accept the loans just because they submitted loan applications or received disclosures. For variable-rate HOEPA loans, lenders must also advise borrowers that their interest rates and monthly payments could increase and provide them with their maximum monthly payment if the loan becomes fully indexed.
The disclosure requirements for HOEPA loans represent marginal improvement over TILA's woefully inadequate disclosures for refinance loans. However, HOEPA does not cover subprime purchase money mortgages. As a result, and because HOEPA's triggers are set so high for refinance loans, HOEPA disclosures apply at most to five percent of subprime first-lien home loans. In any case, it is doubtful that a three-day warning is enough to dissuade a cash-strapped borrower who is desperate enough to pay the stiff rates on HOEPA loans.

2. Real Estate Settlement Procedures Act

RESPA requires lenders who make federally related mortgage loans to provide borrowers with disclosures about their closing costs at two different points in the mortgage process. First, within three business days after application, the lender or mortgage broker must provide an applicant with a good-faith estimate of the settlement costs ("GFE") (Figure 5) and certain other disclosures concerning settlement costs and servicing. This three-day period usually coincides with the three-day period for TILA disclosures (which only applies to purchase money mortgages). Because the GFE only contains limited pricing terms—those related to origination fees—and does not list, for example, the APR, the payment schedule, or the prepayment penalty, it does not remedy the lack of mandatory three-day TILA disclosures for most home refinance loans.

Later, at the closing for all federally related mortgage loans (including refinance loans and reverse mortgages), the settlement agent must furnish the borrower with a standardized form listing the actual settlement costs paid at closing, known as a HUD-1 settlement statement (Figure 6), plus an initial escrow statement. Borrowers have the right to inspect the HUD-1 upon request the day before closing. Like the GFE, the HUD-1...
will only disclose origination costs, not the APR or certain other key disclosures mandated by TILA. Accordingly, lenders who extend home refinance loans (other than the limited set of HOEPA loans) do not have to disclose the APR until the closing.

Under RESPA, injured borrowers have little recourse for false disclosures except to petition HUD for government enforcement. Specifically, borrowers cannot recover damages unless they can prove that lenders: (1) failed to inform them that their loans could be transferred; (2) received illegal kickbacks as defined by RESPA; or (3) steered them to title companies. Lenders have no liability to borrowers under RESPA for errors in GFEs or HUD-I settlement statements, thereby dampening their motives to ensure accuracy.

RESPA's timing rules have the same faults as TILA's timing rules. Lenders do not have to provide GFEs until after consumers have paid a nonrefundable application fee and, while borrowers can request a HUD-I the day before closing, nothing requires lenders to notify borrowers of that right and borrowers are generally ignorant of it. Furthermore, GFEs may have scant resemblance to actual closing costs because lenders are allowed to provide meaningless estimated ranges and do not face suit for inaccurate GFEs. This problem is of particular concern in the subprime market, where settlement costs range from high to plainly exorbitant. As a result, GFEs are not helpful to consumers for comparison-shopping.

In sum, federal disclosure laws are problematic for subprime mortgage customers in four key respects. First, federal law does not require accurate disclosures of the cost of subprime loans before a customer pays a nonrefundable application fee (except for certain variable-rate disclosures). Indeed, under TILA, subprime lenders may advertise their best rates, even if those rates only apply to sterling customers. Second, TILA's variable-rate disclosures are too complex and obscure the information that is most critical to consumers—their worst case payment scenario. Third, for most closed-end home refinance loans other than HOEPA loans, lenders can legally postpone making TILA disclosures on the APR.
and other key price terms until the closing. Lastly, binding cost disclosures are usually not required until closing (except for borrowers who have HOEPA loans or request their HUD-Is the day before closing), which means that lenders can change the loan terms at the eleventh hour with no advance notice to borrowers.

III. CONSUMER SEARCH AND PRICE REVELATION: THE EFFECT OF MARKET FORCES

As the previous discussion suggests, federal disclosure laws do not ensure that consumers get accurate information sufficiently early in the mortgage process to permit low-cost, meaningful comparison-shopping. To the extent that consumers do get timely, accurate information, it is due to market forces, not federal disclosure law.

A. Search in the Prime Market

In the prime market, pricing is highly competitive, lenders market mortgages as commodities, and the market results in roughly homogeneous prices. Prime customers know that identical mortgages go for about the same price and that lenders with competitive rates will prominently advertise discounts. Consequently, consumers will gravitate toward lenders who post prices. Prime lenders know this, which gives them strong incentives to advertise accurate prices in order to attract customers. Today, it is easy to comparison-shop for prime mortgages on the Internet, where standardized price information abounds (Figure 7).

These market forces mean that consumers who shop in the prime market do not have to pay application fees in order to get price quotes. Lenders reveal prices for free. Furthermore, because prices are highly competitive and mortgages are commodities, lenders have to offer consumers an added bonus to get them to apply. This gives consumers leverage to negotiate lock-in commitments and insist on “buy downs” on prices, in the form of interest rate reductions in exchange for points or other fees (Figure 7).90

When TILA was enacted in 1968,91 the prime market was the only conventional mortgage market. That was the market that TILA was designed for. There, market forces ensure that lenders reveal critical price terms—including interest rates, lock-in commitments, and points—upfront

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90 Of course, mortgages with identical terms (such as a 30-year fixed mortgage or a 2/28 hybrid adjustable-rate mortgage) may carry different interest rates depending on the number of points. Each of those pricing structures is a separate product and should be advertised as such.

91 See supra note 12 and accompanying text.

and for free. In tandem with those forces, TILA was designed to standardize voluntary price disclosures. TILA does this relatively effectively for consumers who are prime-eligible and shopping for prime loans.

To be sure, price revelation could stand improvement in the prime market. Problems with RESPA’s timing rules and lack of private enforcement for GFEs make closing costs a continued problem. Hidden transaction costs can be substantial in residential loan transactions and can haunt customers at closing, whether they are in the prime or subprime market. Furthermore, guaranteed closing cost packages are still uncommon even in the prime market, although some lenders do offer them (at least for settlement costs within the lender’s control). The prime market is sufficiently competitive and prime customers are sufficiently savvy that closing cost abuses are less of a problem than in the subprime market. Nevertheless, all home mortgage applicants—prime and subprime—pay too much because of lack of transparency in closing costs. This problem is especially severe with respect to yield spread premia, which are a pernicious form of broker compensation, but it pervades closing costs across the board.

B. Search in the Subprime Market

Consumer search is entirely different in the subprime world, where market forces impede meaningful comparison-shopping. In the subprime market, the market conditions on which TILA was based—lock-in commitments and free and early price revelation—break down. Instead, subprime lenders do not reveal prices until consumers pay to play.

In risk-based pricing, a lender cannot determine the actual price for a loan until the customer reveals information about his or her creditwor-

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92 See, e.g., Kenneth Harney, Guaranteed Closing Costs Are Approaching, DETROIT FREE PRESS, Oct. 9, 2005, at 2F.
94 A yield spread premium is a reward paid by a lender to a mortgage broker for persuading the borrower to pay a higher interest rate than the lowest interest rate that the lender would be willing to accept. As such, yield spread premia are per se anticompetitive and hurt consumer welfare. See, e.g., DEP’TS OF THE TREASURY & HOUS. & URBAN DEV., CURBING PREDATORY HOME MORTGAGE LENDING 40 (2000), available at http://www.huduser.org/Publications/pdf/tearsrpt.pdf (stating that consumer advocates believe yield spread premia encourage brokers to increase interest rates); Predatory Mortgage Lending Practices: Hearing on Abusive Uses of Yield Spread Premium Before the S. Comm. on Banking, Housing, and Urban Affairs, 107th Cong. 56 (2002), available at http://banking.senate.gov/02_01hr/010802/jackson.htm (statement of Howell E. Jackson, Prof. of Law, Harvard Univ.) (concluding that yield spread premia “serve only to [benefit] mortgage brokers,” not consumers, and levy “implicit interest rates [that] are absolutely outrageous”). See generally Howell E. Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums (Jan. 8, 2002) (unpublished manuscript), http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf (arguing that yield spread premia exploit less sophisticated borrowers).
thiness. Today, lenders use the loan application process for that purpose, even though there are other, cheaper ways to research a customer's creditworthiness. As a result, the subprime market requires a customer to apply for a loan, pay a nonrefundable application fee, and go through underwriting to learn the price. Even then, subprime lenders often do not reveal the true price until closing.

1. Lack of Firm Price Quotes Before Application

In the prime market, consumers are able to obtain firm price quotes without charge on interest rates, APR, and points, by consulting advertisements or price lists posted by lenders. In the subprime market, this is virtually impossible because pricing mechanisms are hidden and advertisements usually tout only the lender's best price.

In the subprime market, lenders use their own internal price lists (known as "rate sheets") to determine what price to charge a given borrower for a specific loan. A subprime rate sheet is a grid containing different prices for a specific loan. (Figure 8). This information would be useful to consumers in shopping for loans. Consumers cannot get this information, however, because subprime lenders protect rate sheets as proprietary secrets and only share them with their employees and mortgage brokers (Figure 9, asterisk footnote). Nothing in federal disclosure law prohibits withholding the information on rate sheets from consumers.

Consequently, to comparison-shop before the application stage in the subprime market, consumers must rely on general advertisements or oral representations by mortgage brokers or loan officers. Even though subprime lenders and brokers keep rate sheets secret, that does not hinder them from running advertisements with price quotes. Indeed, it is a common practice for them to quote their best price, whether or not the loan applicant qualifies for it and often without disclaimers. In effect, this operates as an affirmative misstatement for consumers with weaker credit profiles and can induce them to apply for loans that turn out to be higher-priced at closing.

Some advertisements and websites that quote low rates cater specifically to subprime borrowers. Figure 10, for instance, illustrates an Internet site that allowed consumers to shop for mortgages based on their personal credit score. Here, a search on July 4, 2006, for a thirty-year fixed-rate mortgage for a borrower with a weak credit score of 590 resulted in

93 See HUD-FED JOINT REPORT, supra note 23, at 40.
96 See White, supra note 15, at 509-12.
97 See id. (providing examples of subprime rate sheets).
98 See, e.g., Michael Hudson, Popular Mortgage Web Site Under Scrutiny, WALL ST. J., July 12, 2006, at D1 (describing a lawsuit against Bankrate.com for allegedly "allowing its website to become a haven for 'bait-and-switch' loan practices").
99 Generally, Fair Isaac Company ("FICO") scores below 660 are considered to be poorer
quotes ranging from 6.1% with 1.5 points to 6.5% with 2 points. That week, average rates on thirty-year fixed-rate mortgages were 6.78% with 0.5 points, meaning that the rates quoted on the website appeared to be prime rates.100 Only if readers clicked on the link “More info” and scrolled down a long page would they find a disclaimer stating: “Rate/APR and terms may vary based on the creditworthiness of the individual . . . .”101 Given this disclaimer, it is not clear why the website allowed consumers to type in low credit scores at all unless the website was designed to give the misleading impression that a borrower with a 590 credit score would in fact receive the quoted prime rates.

In sum, subprime borrowers who do not qualify for a lender’s best rates do not have the ability to obtain firm quotes before they apply for loans. Making matters worse, consumers with weak credit are likely to be misled by advertising featuring low subprime rates unless they actually qualify for those rates.

2. Lack of Firm Price Quotes After Application

With the exception of HOEPA loans, TILA and RESPA normally do not require firm price disclosures until the closing.102 Neither statute regulates the price terms that a loan officer or broker may enter on the application form. Similarly, neither statute requires firm price terms to be disclosed within three business days after receipt of an application. Instead, if the disclosures on GFEs or preliminary TILA disclosures prove inaccurate, the only cure is accurate disclosure at the closing. By then, however, disclosure is too late. By the closing, the average customer is psychologically invested in the loan and has too much riding on it—such as purchasing a house or refinancing unmanageable debts—to walk away.103


In general, subprime interest rates are at least 200 basis points—two percentage points—above prime rates for comparable products. See White, supra note 15, at 512–13. In contrast, assuming that the borrower takes out a $200,000 loan, the APR on the 6.1% loan with 1.5 points is 6.24% and on the 6.5% loan with 2 points is 6.691%, while the APR on the 6.78% loan with 0.5 points is 6.829% (assuming no other closing costs for the loan). This means that the rates quoted on the website were probably better than prime rates.

101 In the search, the link “more info” appeared at http://www.myfico.com/LoanCenter/Results.aspx?Fire=11&States=22&Markets=257&LoanTypes=4&LowerLimit=&UpperLimit=&Score=590 (last visited July 4, 2006). Clicking on the link led to the disclaimer. Subsequently, this website took down these pages and changed its search methodology.


103 See, e.g., Baher Azmy, Squaring the Predatory Lending Circle, 57 Fla. L. Rev. 295, 351–52 (2005) (stating that on the day of the loan closing “a borrower has psycho-
Subprime lenders can take advantage of legally sanctioned late disclosures to turn the terms and prices of subprime loans into a moving target and thereby achieve monopolistic pricing. A lender or broker might direct a customer to apply for one type of loan at Price A—say, a fixed-rate loan—change the loan during underwriting to an adjustable-rate mortgage at Price B, and change the loan again at closing to something different, such as an interest-only adjustable-rate mortgage, at Price C. Not surprisingly, the final price is often higher than the original quoted price.

The moving target problem is even worse for refinance loans that are not governed by HOEPA. In these cases, lenders do not even need to provide three-day TILA disclosures and can wait until closing to make their first loan-specific disclosures about the loan’s APR. The case of Lucy Brown is instructive. In 1998, Ms. Brown applied for a thirty-year fixed-rate refinance loan at a nominal interest rate of 10.75%. Her preliminary TILA disclosure stated an 11.013% APR and a finance charge of $189,903.90. The disclosure said that her loan had no variable rate feature or prepayment penalty. During underwriting, the lender rated Ms. Brown as an “A” grade borrower who presumably qualified for a prime-rate loan.

Nevertheless, with no advance notice, the lender presented Ms. Brown at closing with a high-fee variable-rate loan carrying a large prepayment penalty and an initial nominal interest rate of 11.25%. The final TILA disclosure, first presented to her at closing, revealed that her APR had risen 27.64% to 14.085% and her finance charge had jumped 38.56% to $263,133.60. If Ms. Brown had received a prime loan, it would have cost her far less: at the time, the average prime-rate fixed thirty-year home mortgage carried a nominal interest rate of 7.00% and one point. The mortgage broker’s file on Ms. Brown contained four different loan applications, each for a fixed-rate loan on different terms. She only signed two of the applications and none was for the variable-rate loan she ultimately got.

Sometimes lenders have legitimate reasons to change the loan terms during underwriting. For instance, the lender may decide that the applicant could not qualify for the loan requested, either on the face of the application or because the application was incomplete and subsequent facts revealed underwriting problems. Even legitimate reasons to change the loan terms, however, do not justify allowing lenders to wait until the closing to reveal the change in terms, as TILA and RESPA usually permit.

Other times, lenders and brokers have underhanded motives for switching the loan terms and springing them on the borrower at closing. For instance, behind the scenes, brokers may negotiate a yield spread pre-
mium in exchange for higher interest payments to the lender. In Ms. Brown's case, the lender paid the broker a $2373 yield spread premium as a reward for increasing the interest rate on the loan from 10.75% to 11.25% and for changing the loan from a fixed-rate loan to a riskier adjustable-rate loan with a large prepayment penalty. Before the closing, the broker did not tell Ms. Brown that it would receive a large yield spread premium in exchange for driving up the cost of her loan. In Ms. Brown's case, the result was a bait-and-switch.

Of course, if customers could negotiate lock-in commitments with subprime lenders, they could largely avoid the moving target problem. Subprime customers with weak credit, however, have reduced leverage to insist on those commitments because lenders know these customers have fewer options and cannot qualify for prime credit. Subprime customers, moreover, tend to be less well-educated and less sophisticated about the mortgage market. Subprime lenders, knowing that they can usually delay firm price quotes until closing under TILA and RESPA, have no legal compunction to offer lock-in commitments. This leaves subprime borrowers vulnerable to nasty surprises at closing.

3. Problems with Variable-Rate Disclosures

Variable-rate loans are now the dominant first-lien loan product in the subprime market. Recently, two new types of adjustable-rate mortgages ("ARMs") have cropped up in the subprime market: interest-only ("I-O") ARMs and option ARMs. These mortgages present substantially greater risks of payment shock than traditional ARMs. This heightened risk, especially to subprime borrowers, underscores the urgency of reforming variable-rate TILA disclosures.

In I-O mortgages, borrowers only pay interest for an initial period lasting anywhere from six months to five years. Once the introductory period expires, the borrowers' payments go up, often substantially, for up to four distinct reasons. First, the loan begins to amortize and borrowers start paying principal as well as interest. Second, the principal payments are higher than they would be under a fully amortizing loan because there are fewer years left to pay off the principal. Thus, in a thirty-year I-O ARM with a three-year introductory period, the principal will normally be paid off in twenty-seven years, not thirty. Third, if interest rates are rising, the variable-rate on the loan will go up on the reset date. Finally, numerous I-O ARMs offer introductory teaser rates that are below the in-

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106 See supra note 94 and accompanying text.
107 See Lax et al., supra note 14, at 544–56.

Option ARMs are cousins of I-O ARMs and potentially even riskier. During the introductory period for an option ARM, a borrower can choose among four payment options: accelerated amortization of principal (over fifteen years), normal amortization (over thirty years), interest-only payments, or a low minimum payment that does not even pay off the interest due that month.\footnote{See FISHBEIN & WOODALL, supra note 99, at 7; FRATANTONI ET AL., supra note 109, at 56.} If a borrower opts for the minimum payment—as do up to seventy percent of option ARM borrowers\footnote{See FRATANTONI ET AL., supra note 109, at 56.}—the unpaid interest will be added to principal, causing the loan balance to grow.\footnote{When this happens, the loan “recasts.” See Cagan, supra note 109, at 17; Simon, supra note 109, at R4.} This negative amortization makes the initial monthly payments enticing. Once the introductory period expires, however, the borrower must start making regular principal and interest payments for the remainder of the loan. Option ARMs present the same risks of payment shock as I-O ARMs, plus the risk that the principal may grow over time due to negative amortization, further increasing the eventual payments. Even before the introductory period expires, payments can also go up if negative amortization boosts the balance on the loan above a specified level, generally 110% to 125% of the original loan amount.\footnote{Cagan, supra note 109, at 29.} For all of these reasons, option ARMs “are the most likely” of all nontraditional mortgages “to default.”\footnote{Doug Duncan, Mortgage Bankers Ass’n, MBA Nonprime Conference 18 (May 22, 2006), http://www.mbaa.org/files/Conferences/2006/Non-Prime/MarketOutlook.ppt#397 (last visited Oct. 19, 2006). In the first quarter of 2006, originations of I-O loans dropped thirty percent from the previous quarter but still remained substantial. Standard & Poor’s, Sector Report Card: The Heat Is On For Subprime Mortgages 3 (July 10, 2006) (S&P Ratings Direct).} Both types of loans have made inroads into the subprime market. By the third quarter of 2005, over one-quarter of new subprime loans were I-O loans.\footnote{See Fishbein & Woodall, supra note 99, at 7; Fratantoni et al., supra note 109.} Similarly, a recent study found that option ARM borrowers had “lower credit scores than borrowers overall” and often had subprime
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credit scores (usually defined as FICO scores below 660). The same study found that African American and Latino borrowers were more likely to receive I-O and option ARMs than non-minority borrowers even after controlling for income, debt loads and credit scores.

There are substantial reasons for concern about the payment shock associated with I-O and option ARMs, particularly for cash-strapped subprime borrowers. One industry commentator warned that when interest rates reset from teaser rates, monthly payments could double on both types of loans, placing the affected borrowers in financial jeopardy:

It is important to note that a household facing a doubling of mortgage payments will be in difficulty, whether that increase is applied in a single month or in a series of incremental steps spread over two years . . . . [A] loan with an initial [teaser] rate of 1 percent that resets to a market rate of 6.3 percent will experience a substantial increase in payments, all the more so if negative amortization has increased the total principal amount subject to interest. That type of loan will experience reset payment sensitivity. An option-payment loan with a minimum payment below that of a 1 percent loan will face even greater reset sensitivity.

These dynamics can and do lead to increased subprime default rates. A recent Fannie Mae analysis of subprime ARMs that underwent rate reset and were originated between March 2003 and March 2004 found, for instance, that sixteen percent of the borrowers had defaulted or were late making payments by mid 2006.

The prevalence of I-O and option ARMs in the subprime market suggests that these loans are often underwritten for the wrong reason. Due to

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166 See Fishbein & Woodall, supra note 99, at 25–26; see also White, supra note 15, at 509 n.2.
168 Cagan, supra note 109, at 19 (emphasis in original); see also id. at 21, 25 (noting that when “[teaser-rate] loans finally adjust to fully-amortizing market-rate levels, the payments will have increased by more than fifty percent from their initial amounts. Often the payments will have doubled, or more than doubled.”); Simon, supra note 109, at R8 (“If rates go up by two percentage points, monthly payments could nearly double.”). While Cagan discounted the presence of teaser rates and thus of the severity of reset adjustments for subprime loans, Cagan, supra note 109, at 21, Fitch Ratings reported in 2006 that the “current environment” was of “deeply teased short-term subprime hybrid ARMs combined with an interest-only affordability feature.” Fitch Ratings, Rating Subprime RMBS Backed By Interest-Only ARMs 1 (Mar. 9, 2006); see also Interagency Guidance on Nontraditional Mortgage Product Risks: Final Guidance, 71 Fed. Reg. 58,609, 58,613–14 (Dep’t of the Treas. et al. Oct. 4, 2006).
the potential for large payment shock, these products are best suited for borrowers who have large disposable incomes, receive bonuses, or expect their income to rise sharply during the introductory period. None of these conditions normally hold for subprime borrowers. Rather, subprime borrowers usually take out these loans to minimize their monthly payments on large loan balances. Sometimes they do so to buy a larger house or refinance large debts. Other times, they do so to buy a starter home in regions where payments on a fixed-rate loan on a starter home would exceed their means. This is particularly common in overheated coastal real estate markets such as California. Many lenders approve these loans to subprime borrowers based solely on a household’s ability to pay the initial monthly payments, not on the possible maximum payments. As Fitch, a leading credit rating agency, has warned, however, when lenders qualify financially strapped borrowers for loans only “at the initial rate and IO payments,” not the larger eventual payments, “payment shock is exacerbated.” When the loans reset and the payments go up, many of these borrowers will find that they can no longer afford the payments. At that point, borrowers will either have to refinance (which likely will be difficult), sell their homes, or go into default. Fitch predicts that as “home prices stabilize and interest rates rise, . . . subprime IO delinquency rates [will] increase.”

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120 See Cagan, supra note 109, at 17 (commenting that “[t]hese loans . . . may be useful to homeowners who anticipate substantial increases in their income (such as recent graduates from law school), and to those who have low incomes for most of the year but receive high lump sum payments from time to time (such as people who are self-employed or professionals who receive much of their income in the form of a yearly bonus)”; Fratantoni et al., supra note 109, at 55–56 (describing the types of borrowers IO loans were designed for); Simon, supra note 109, at R4.

121 See Cagan, supra note 109, at 14, 17 (observing that “many adjustable-rate mortgage borrowers . . . bought recently and stretched their financial abilities to acquire a home with a low down payment and a low monthly payment”); see also Fratantoni et al., supra note 109, at 56, 58 (stating that some borrowers use IO loans to “extend their purchase power as house prices have increased”); Ruth Simon, Option ARMs Remain Popular In Spite of Risks, WALL ST. J., Aug. 15, 2006, at A2 (stating that “borrowers seeking to lower their monthly payments have few other choices” than option ARMS).

122 See Fishbein & Woodall, supra note 99, at 4; Fratantoni et al., supra note 109, at 50.

123 See Shenn, supra note 109 (reporting that lending “standards loosened throughout 2004 and 2005, particularly through the increased use of ‘stated’ incomes, higher debt-to-income ratios, and low down payments”). In 2006, federal banking regulators issued an interagency guidance that requires federally insured depository institutions who make IO and option ARM loans to “address the effect of a substantial payment increase on the borrower’s capacity to repay when loan amortization begins.” Interagency Guidance on Nontraditional Mortgage Product Risks: Final Guidance, 71 Fed. Reg. at 58,613 (Oct. 4, 2006). The regulators issued the proposed guidance out of concern that these products “are now offered by more lenders to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgage loans and may not fully understand the associated risks.” Id.

124 Fitch Ratings, supra note 118, at 11.

125 See id. at 10–11.

126 Id. at 13; see also Interagency Guidance on Nontraditional Mortgage Product Risks: Final Guidance, 71 Fed. Reg. at 58,609, 58,616 (expressing concern that “interest-only
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Consequently, it is essential that all borrowers, including subprime borrowers, understand the worst case payment scenario before they take out I-O and option ARMs. Current TILA disclosures—based on an unrealistic, hypothetical $10,000 loan—are impossible for most consumers to comprehend. Even a sophisticated borrower would need to locate the hypotheticals in the sea of variable-rate disclosures and take the time to do the math. Thus, it comes as no surprise that residential borrowers with adjustable-rate mortgages “appear to underestimate the amount . . . their interest rates can change.” Borrowers with less income or education seem especially likely not to know their mortgage terms,” making them “more vulnerable to an increase in interest rates.”

IV. WHAT TO DO?

For all of these reasons, federal mortgage disclosures break down in a world of risk-based pricing. TILA and RESPA do not mandate reliable information for meaningful comparison-shopping in the subprime market before application and the subprime market does not provide it. In fact, TILA unwittingly countenances affirmative misrepresentations to subprime customers by permitting lenders to tout their best rates and nothing else. Similarly, in most cases, nothing in TILA or RESPA requires lenders to provide firm price disclosures until the date of closing. These problems are compounded for variable-rate loans because current variable-rate disclosures obscure what is most important to subprime borrowers—the worst payment case scenario. While revamped disclosures are not a panacea for price revelation problems in the subprime market, they are an important part of the solution.

A. Counteracting False Subprime Advertising

Currently, virtually all subprime ads that publicize rates only quote the best rates (and, for variable-rate loans, often these are teaser rates). For everyone except customers who actually qualify for the advertised rates, these ads are patently misleading. If comparison-shopping is to be mean-
ingful, it is critical to eliminate false advertising that is designed to lead consumers down the primrose path to higher, hidden prices. Concomitantly, improved oversight could help make subprime advertising a vehicle for accurate price revelation.

Achieving truth in subprime advertising requires four distinct measures. First, any lender who advertises an APR for a subprime product should be required to advertise the full range of APRs that it charges for that product. Immediately next to this price range, a warning needs to appear stating that customers with weak credit will not qualify for the best price. Second, both of these disclosures need to be prominent, in boldface, and in a large font. Third, for ads marketing adjustable-rate mortgages, the text should conspicuously state the maximum APR cap for the highest-priced version of the loan to inform consumers of the worst case payment scenario. Finally, Congress should amend TILA and RESPA to provide a private right of action to borrowers who enter into detrimental loans in reliance on misleading subprime advertisements. The first three measures fall well within the regulatory authority of the Federal Reserve Board to interpret TILA.

B. Providing Firm Price Quotes to Subprime Customers Before Application

In an ideal world, subprime customers could get firm quotes for free without paying for a mortgage application and could then shop those quotes with other lenders. The wrinkle, of course, is that subprime customers have to reveal their creditworthiness before lenders can compute a price. Today, that is accomplished through the loan application process, complete with a large nonrefundable application fee. However, given the prevalence of rate sheets, automated credit scores, and automated underwriting, there is no reason why subprime customers should have to make costly formal applications in order to obtain firm price quotes.

The costs of subprime mortgages fall into two broad categories: price terms and closing costs.\textsuperscript{131} Price terms include interest, points, origination fees, broker fees, yield spread premia, and prepayment penalties. Under risk-based pricing, these terms can be computed by consulting a lender's rate sheet and determining where customers fall on that rate sheet, depending on their credit scores and loan-to-value ratios. Alternatively, lenders who determine prices using more sophisticated automated underwriting systems could interview the customer for the key underwriting variables, enter those variables in the system, and obtain a price quote in seconds.\textsuperscript{132} With the customer's permission, a lender can obtain the customer's credit report and credit scores online for no more than ten to fifteen dollars.\textsuperscript{133} Similarly, the loan-to-value ratio can be estimated using the proposed down payment and the purchase price of the home.

Consequently, it is now feasible for lenders and brokers to provide firm, upfront price quotes to subprime customers at minimal cost. Indeed, HUD reached that conclusion in 1998, when it proposed requiring lenders and brokers to provide firm price quotes before application in exchange for giving lenders and brokers immunity from RESPA's anti-kickback provisions.\textsuperscript{134} Eight years have elapsed since then and automated underwriting systems have become prevalent in the subprime industry.\textsuperscript{135} By

\textsuperscript{131} See generally HUD-FED JOIN'T REPORT, supra note 23, at 40-41.

\textsuperscript{132} For descriptions of automated underwriting for applicants with weak credit, see generally Susan Wharton Gates et al., Automated Underwriting in Mortgage Lending: Good News for the Underserved?, 13 HOUSING POL 'Y DEBATE 369 (2002); Susan Wharton Gates et al., Automated Underwriting: Friend or Foe to Low-Mod Households and Neighborhoods? (Freddie Mac Working Paper, 2003); and John W. Straka, A Shift in the Mortgage Landscape: The 1990s Move to Automated Credit Evaluations, 11 J. HOUSING RES. 207 (2000).


\textsuperscript{135} See HUD-FED JOIN'T REPORT, supra note 23, at 22, 29-30; HUD Guaranteed Package Rule, supra, at 49160-61. The inducement did not work and, more importantly, is economically perverse. Provisions in TILA and RESPA that allow lenders to change most loan terms until the last minute promote anticompetitive practices by allowing lenders and brokers to negotiate yield spread premia in exchange for higher rates behind the scenes and then spring costlier loans on borrowers at closing. See Jackson, supra note 94, at 3; Jackson & Berry, supra note 94. Accordingly, any proposal for a guaranteed closing cost package should ban the use of yield spread premia in exchange for higher interest rates, points, fees or prepayment penalties.

\textsuperscript{135} According to Fitch Ratings, automated "compliance systems have become a critical component of the underwriting and quality control process" in the subprime residential mortgage industry. Press Release, Fitch Ratings, Fitch Revises RMBS Guidelines for Antipre-
now, there is no doubt that lenders and brokers have the technical capability to provide firm, written price quotes to subprime customers, if not for free, then for the cost of pulling the credit report. Lenders should be required to provide such quotes for all loans using risk-based pricing, according to a fee schedule regulated by law, instead of demanding large non-refundable application fees in order to reveal prices.

Critics have argued that lenders cannot provide firm price quotes before verifying customer representations or entering into lock-in commitments. While sometimes these are legitimate concerns, neither poses an insuperable bar. Price quotes are always contingent on verification in the prime market and the same would be true in the subprime market. In the subprime context, moreover, the only information that requires verification on numerous rate sheets is the loan-to-value ratio (calculated from the down payment and the property value), because the credit history and score are available from a trusted third party online. In any event, the surge of low-documentation and no-documentation loans in the subprime market belies a strict need for many types of verification. And as for the issue of lock-in commitments, HUD proposed a satisfactory resolution of that issue in 1998:

The [price term] guarantee would stand for a reasonable time to permit the consumer to shop. And unless the borrower chose to formally apply and “lock” the interest rate, any subsequent change in interest rate and points (but not closing costs) would be permitted, so long as any change to the consumer’s guaranteed rate was solely attributable to, and commensurate with, changes in the financial markets.

HUD’s language similarly underscores the need for lenders to offer lock-in commitments as a standard option in the subprime market.

As for closing costs, the time has come to require legally binding quotes on guaranteed closing cost packages in advance of payment of a nonrefundable application fee. This reform is long overdue in the prime market, but it takes on special urgency in the subprime market, where closing costs are substantially higher on average, relative to the amount


136 See HUD-FED JOINT REPORT, supra note 23, at 40–41.
137 See id. at 42.
138 Id. In addition to interest rate and points, the lock-in commitment should also cover origination fees and prepayment penalties.
139 HUD and the Federal Reserve Board advanced a similar proposal in 1998. See id. at 32–33. HUD formally proposed a guaranteed closing cost rule in 2002 but eventually put the proposal on the back burner due to industry and consumer group opposition. See HUDBorrowed Package Rule, supra note 134; Semiannual Regulatory Agenda, 71 Fed. Reg. 22,733, 22,751 (Dep’t of Hous. & Urban Dev. Apr. 24, 2006).
Disclosure in a World of Risk-Based Pricing

financed, than in the prime market. Guaranteed packages would include numerous settlement costs associated with subprime mortgages, including fees for services provided by creditors and third-party vendors, plus official filing and recording fees. Examples of these costs include broker compensation and fees for appraisals, surveys, credit reports, underwriting, recording, legal representation, title insurance and title searches.\(^{140}\) Guaranteed packages would need to go hand-in-hand with firm price quotes to prevent lenders from undermining the closing cost quotes by increasing the price terms after the fact.\(^{141}\) Lenders would continue to have to provide borrowers with HUD-1s at closing to permit borrowers to verify that guarantees were honored. Providing customers with guaranteed closing cost packages before application would enable them to comparison-shop intelligently for closing costs.

The Federal Reserve Board and HUD have full authority to accomplish firm price quotes through notice-and-comment rulemakings. TILA requires disclosures “before the credit is extended,”\(^{142}\) which gives the Board ample latitude to require firm price term disclosures early in the shopping process. Similarly, HUD felt confident enough about its authority to mandate a guaranteed closing cost package under RESPA that it proposed a rule to that effect in 2002.\(^{143}\) Thus, firm price quotes could be attained without additional congressional authorization.

C. Addressing the Moving Target Problem

Requiring firm price quotes and guaranteed closing cost packages would go a long way toward addressing the moving target problem in the subprime market. It would not entirely eliminate the problem, however. The price quotes just proposed would be subject to verification and could be raised if the customer’s creditworthiness turned out to be worse than originally portrayed. Similarly, lenders would have latitude, absent lock-in commitments, to increase price terms to account for interest rate movements. Accordingly, the need for verification and financial market movements create openings for the moving target problem and the potential for surprise price hikes at closing.

While the moving target problem cannot be wholly eliminated, it can be substantially constrained. First, the reasons for any price hike should be strictly regulated. Lenders should only be allowed to alter price quotes

\(^{140}\) See HUD-Fed Joint Report, supra note 23, at 23–25. Note that some cost items overlap the categories of prime terms and closing costs. The cost of homeowners’ insurance and transfer taxes would be excluded from guaranteed closing cost packages because these items depend on consumer choices unrelated to the credit transaction. See id. at 24. For discussion of other operational issues in implementing guaranteed closing cost packages, see id. at 25–31.

\(^{141}\) See id. at 22, 28–29.


\(^{143}\) See HUD Guaranteed Package Rule, supra note 134.
for three reasons: (1) good faith subsequent discoveries or events resulting in a downgrade of a customer's creditworthiness; (2) lower-than-expected appraisals affecting loan-to-value ratios; and (3) prevailing interest rate movements after application (barring any lock-in commitment), and only on the condition that any price changes be commensurate. With respect to (1), lenders would be barred from raising prices with respect to information (such as prior delinquencies or bankruptcies) that was already available from the customer's online credit report on the date of the price quote. Furthermore, no price changes would be allowed that result from behind-the-scenes compensation negotiations for mortgage brokers, loan officers, or other lending personnel.

Second, if legitimate reasons did exist for price changes, only the nominal interest rate, discount points, or origination fees could be changed. The lender could not unilaterally change any closing costs (including yield spread premia if they were regrettably still permitted)\textsuperscript{144} that were guaranteed in the closing cost package. Limiting price increases to the nominal interest rate, discount points, or origination fees would help promote transparency in pricing.

Lastly, lenders who raise price quotes should be required to deliver to the affected borrowers written disclosures announcing any new nominal interest rate, points, origination fees, finance charge, and APR. These disclosures should be made no later than seven days before the closing.\textsuperscript{145} In cases where the lender also changes the loan product (such as from a fixed-rate loan to an adjustable-rate loan), the new variable rate disclosures discussed in the next section would be required, where applicable. Delivery of such disclosures would be automatic and would not require a prior request by the borrower. The accuracy of all new disclosures and price terms should be legally binding on the lender and should entitle the borrower to damages if breached.\textsuperscript{146} In addition, any unilateral change in terms at closing by the lender should entitle the borrower to a three-year right of rescission.\textsuperscript{147}

All of these changes except the expanded right of rescission under TILA could be jointly accomplished by HUD under RESPA and the Federal Reserve Board under TILA without additional congressional authority. Indeed, HUD embraced many of these changes in its proposed guaranteed closing cost package rule in 2002.\textsuperscript{148}

\textsuperscript{144} See supra note 94.
\textsuperscript{145} Tolerances could be used to excuse lenders from redisclosure for minor changes in the APR. Tolerances of one-eighth of one basis point for regular transactions and one-quarter of one basis point for irregular transactions would be appropriate. See supra note 64 and accompanying text. Tolerances refer to margins “within the TILA’s ‘tolerance’ for error.” See Renuart & Keest, supra note 18, § 4.6.3.2.1.
\textsuperscript{146} See HUD-Fed Joint Report, supra note 23, at 44.
\textsuperscript{147} See supra note 40.
\textsuperscript{148} See HUD Guaranteed Package Rule, supra note 134.
Currently, variable-rate disclosures under TILA must recite most of the individual moving parts that drive the worst case payment scenario, such as the index, the margin, reset dates, individual reset caps, and lifetime maximum and minimum interest caps (Figures 3a-3c). These drivers of the worst case payment scenario are also found in the loan note at closing. What most consumers care about, however, is not the moving parts, but how high their principal and interest payments could go if the loan becomes fully indexed (and becomes fully amortizing, in the case of I-O and option ARM loans). Moreover, consumers want the actual worst case dollar figures for their own loans, not extrapolations from a $10,000 hypothetical. Today, automated programs make tailored disclosures such as these cheap and easy for lenders to provide.

Accordingly, variable-rate disclosures should be pared down and revised to contain just four things. First, these disclosures should make it unmistakably clear that the borrower has an adjustable-rate loan. Second, the disclosures should state the number of months or years until the first reset date and the maximum interest rate and monthly principal and interest payment on that date for the actual loan in question. Third, the disclosures should state the earliest date on which the loan could become fully indexed and the maximum interest rate and monthly payment on that date. Finally, the disclosures should state whether the loan will contain a prepayment penalty, and if so, the maximum dollar value of that penalty and how long it would last. The disclosures would look something like this:

You have asked for information about a variable-rate loan. With this loan, your interest rate and monthly payments would likely increase over time.

- In **two years** from the closing, your principal and interest payments could rise as high as $1,950 per month and your annual percentage rate could rise as high as 9.50%.
- In **six years** from the closing, your principal and interest payments could rise as high as $2,572 per month and your annual percentage rate could rise as high as 14.00%. This is the highest your principal and interest payments could go under this loan.

**Warning:** If you pay off most or all of your loan within two years of the closing, you will have to pay your lender a penalty of as much as $9,000.

Lenders would have to provide these disclosures in writing along with the initial firm quotes (or, for prime loans, before provision of an application form or payment of a nonrefundable fee, whichever is earlier). In cases where the lender later changed the price terms or loan product

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149 See supra notes 58–61, 109–114 and accompanying text.
for permissible reasons, it would need to make new, written variable-rate disclosures (where applicable) no less than seven days before closing.

No congressional authorization would be needed to make this change. The Federal Reserve Board has full authority under TILA to implement these changes.\textsuperscript{150}

\textbf{CONCLUSION}

Currently, the prime market and subprime markets are segmented. The prime market uses average-cost pricing and the subprime market uses risk-based pricing. But there is every reason to think that risk-based pricing will eventually pervade the prime market and lead to the demise of average-cost pricing. The residential mortgage market has already started down this road with the invention of the "A-" customer (with slightly weaker credit than the typical prime market borrower) and the "Alt-A" customer (who looks strong on paper, but provides little or no documentary support of income or employment). Eventually it is likely that we will have other shades of "A" borrowers, each of whom receives an individualized price.

Current federal mortgage disclosures have broken down in the face of risk-based pricing. This Article advances proposals to repair mortgage disclosures and, in the process, to make it truly possible to meaningfully comparison-shop for residential mortgages in a world of risk-based pricing.

Uniform Residential Loan Application

This application is designed to be completed by the applicant(s) with the Lender’s assistance. Applicants should complete this form as "Borrower" or "Co-Borrower," as applicable. Co-Borrower information must also be provided (and the appropriate box checked) when the income or assets of a person other than the Borrower (including the Borrower’s spouse) will be used as a basis for loan qualification or when the income or assets of the Borrower’s spouse or other person who has community property rights pursuant to state law will not be used as a basis for loan qualification, but his or her liabilities must be considered because the spouse or other person has community property rights pursuant to applicable law and Borrower resides in a community property state, the security property is located in a community property state, or the Borrower is relying on other property located in a community property state as a basis for repayment of the loan.

If this is an application for joint credit, Borrower and Co-Borrower each agree that we intend to apply for joint credit (sign below):

<table>
<thead>
<tr>
<th>Borrower</th>
<th>Co-Borrower</th>
</tr>
</thead>
</table>

**I. TYPE OF MORTGAGE AND TERMS OF LOAN**

<table>
<thead>
<tr>
<th>Mortgage Applied for:</th>
<th>VA</th>
<th>FHA</th>
<th>Conventional</th>
<th>USDA/Rural</th>
<th>Other (explain):</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housing Service</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amount</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of Months</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization Type</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other (explain):</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GPM</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ARM (type):</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**II. PROPERTY INFORMATION AND PURPOSE OF LOAN**

<table>
<thead>
<tr>
<th>Subject Property Address (street, city, state &amp; ZIP)</th>
<th>No. of Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal Description of Subject Property (attach description if necessary)</td>
<td>Year Built</td>
</tr>
<tr>
<td>Purpose of Loan</td>
<td>Purchase</td>
</tr>
<tr>
<td>Property will be:</td>
<td>Primary Residence</td>
</tr>
</tbody>
</table>

Figure 1 (partial view):
## TRUTH IN LENDING DISCLOSURE STATEMENT

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Applicant(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Mailing Address</th>
<th>Property Address</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Loan Number</th>
<th>Preparation Date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### ANNUAL PERCENTAGE RATE
- The cost of your credit as a yearly rate.

### FINANCE CHARGE
- The dollar amount the credit will cost you.

### Amount Financed
- The amount of credit provided to you or on your behalf.

### Total of Payments
- The amount you will have paid over your monthly payment as scheduled.

### PAYMENT SCHEDULE:

<table>
<thead>
<tr>
<th>NUMBER OF PAYMENTS</th>
<th>* AMOUNT OF PAYMENTS</th>
<th>MONTHLY PAYMENTS ARE DUE BEGINNING</th>
<th>NUMBER OF PAYMENTS</th>
<th>* AMOUNT OF PAYMENTS</th>
<th>MONTHLY PAYMENTS ARE DUE BEGINNING</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Includes mortgage insurance premium, excludes taxes, hazard insurance or flood insurance.

### DEMAND FEATURE:
- [ ] This loan does not have a Demand Feature
- [x] This loan has a Demand Feature

### ITEMIZATION:
- [ ] You have a right at this time to an ITEMIZATION OF AMOUNT FINANCED.
- [x] We [ ] do [ ] do not want an itemization.

### REQUIRED DEPOSIT:
- [ ] The annual percentage rate does not take into account your required deposit.
- [x] This loan has a Demand Feature.

### VARIABLE RATE FEATURE:
- [x] The Loan has a Variable Rate Feature. Variable Rate Disclosures have been provided to you earlier.

### SECURITY:
- You are giving a security interest in:

### ASSUMPTION:
- [ ] Someone buying this property
- [ ] You may assume, subject to lender's conditions, the remaining balance due under original mortgage terms.

### FILING / RECORDING FEES: $ [ ]

### PROPERTY INSURANCE:
- [x] Property / hazard insurance is a required condition of this loan. Borrower may purchase this insurance from any insurance company acceptable to the lender.

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Figure 2 (partial view):
1 MONTH PAYMENT OPTION ARM (1 MONTH LIBOR INDEX)
MORTGAGE PROGRAM DISCLOSURE

This payment option adjustable rate mortgage program disclosure describes the features of the payment option adjustable rate mortgage (ARM) program you are considering. The interest rate and payment amount of your loan are subject to change. Monthly payments may not be enough to cover the interest due, and any difference will be added to your principal balance. Therefore, the principal amount to repay the loan could be greater than the amount originally borrowed. This is known as negative amortization. The loan will have a term of 30 years. Information on other ARM programs is available upon request.

This disclosure is not a contract or commitment to lend. Only your promissory note, security instrument, and other documents will establish your rights under the loan. This disclosure addresses how you will repay the principal and interest on your loan. It does not address any other payments that may be required under the terms of your loan, for example, monthly escrow payments.

How Your Interest Rate is Calculated

1. Index. The “Index” is the average of interbank offered rates for one month U.S. dollar-denominated deposits in the London market (“LIBOR”) as published in The Wall Street Journal. The most recent Index figure available as of the first business day of the month immediately preceding the month in which your Interest Rate could change is called the “Current Index.” If the Index is no longer available, we will choose a new Index that is based upon comparable information. We will give you notice of this choice.

2. Margin. The “Margin” is the amount added to the Current Index to establish your interest rate. It is expressed in percentage points. Ask us about our current Margin.

3. Interest Rate. Starting with the first interest rate adjustment on your loan, the “Interest Rate” (the interest rate applicable to your loan) will be calculated by adding the Current Index to the Margin. We will then round the result of this addition to the nearest one-eighth of one percentage point (0.125%). This rounded amount will be your new Interest Rate until the next date on which your Interest Rate could change. Your Initial Interest Rate will be established and disclosed to you prior to closing. Ask us for our current interest rate.

Figure 3a (p.1, partial view):
http://www.thornburgmortgage.com/thornburg/portals/0/Lend_Media/1MonthLIBOROptionARMDisclosure.pdf
Ask us about our current interest rate and the amount of any Premium or Discount. If you choose an interest rate commitment option that provides for a floating rate, your Initial Interest Rate at closing may be different than the interest rate in effect at the time you apply for your loan. The amount of the Premium or Discount may change as a result.

How Your Interest Rate Can Be Adjusted

1. **Calculation of the Interest Rate Adjustment.** The first adjustment to your Interest Rate will occur in approximately 1 month on the due date of your first monthly payment. After that, your Interest Rate will be scheduled to change on the same date every month. Each date on which your Interest Rate is scheduled to change is called an “Interest Rate Change Date.” The Index used to calculate your new Interest Rate is the one that was in effect on the first business day in the month before the month of the applicable Interest Rate Change Date. Your Interest Rate will be determined by adding the Current Index to the Margin and rounding the total to the nearest one-eighth of one percentage point. The Interest Rate may change monthly, but the monthly payment is recalculated as described below.

2. **Interest Rate Caps.** Over the term of the loan, your Interest Rate cannot be greater than 9.95%.

How Your Payment is Calculated

1. **Amount of Payment.** Your initial monthly payment will be based on the Initial Interest Rate. Beginning with the 13th payment in the loan documents and every 12 months thereafter (the “Payment Change Date”), we will calculate the amount of the monthly payment that would be sufficient to repay the unpaid principal balance in full by the maturity date in substantially equal payments at the interest rate in effect during the month preceding the payment change date. This payment is called the “Full Payment.” Except as otherwise provided in the loan documents, your “Limited Payment” will be the payment amount for the month preceding the payment change date increased by no more than 7.5% of such payment (“Payment Cap”). Your new “Minimum Payment” will be the lesser of the Limited Payment and the Full Payment. You also have the option to pay the Full Payment for your new monthly payment. If you pay less than the Full Payment, then the payment may not be enough to cover the interest due, and any difference will be added to your principal balance. This means the balance of your loan could increase. This is known as “negative amortization.” During the loan term, we may provide you with other monthly payment options that are greater than the Minimum Payment, such as interest only payments, fully amortizing payments or 15 year amortized payments (“Payment Options”). Please ask us about these Payment Options.

Figure 3b (p.2, partial view): http://www.thornburgmortgage.com/thornburg/portals/0/Lendedia/1MonthLIBOROptionARMDisclosure.pdf
How Your Payment Can Change

1. **New Payment Amount.** Your monthly payment every year can increase or decrease substantially based on changes in the interest rate. At every 5th Payment Change Date the Minimum Payment will be the Full Payment until the next Payment Change Date.

2. **Notice of Adjustment.** You will be notified in writing at least 30 days before the due date of a payment at a new amount. The notice will include information about the interest rate, payment amount and loan balance.

3. **Maximum Increase in Principal Amount.** The maximum principal amount of your loan can never exceed 115% (110% in New York) of the original amount borrowed. If your principal amount rises to this point, your monthly payment may change more frequently than annually and the payment change will not be limited by the 7.5% Payment Cap. The new Minimum Payment will be set each Payment Change Date thereafter and will be in an amount that would be sufficient to pay off the unpaid principal balance over the remaining life of the loan at the current interest rate.

4. **Maximum Rate and Payment Examples.** For example, on a $10,000 30 year loan with an initial interest rate of 1.0%* (which is discounted by 5.875% based on the index for March 2006 of 4.823% plus a margin of 2.00%), the maximum amount that the interest rate can rise under this program is to 9.95%. We assume the interest rate will increase to the maximum rate as rapidly as possible. Because of the 7.5% payment cap, the monthly payment would rise from an initial payment of $32.16 to a payment of $34.57 in the 13th month and $37.16 in the 25th month. As a result of the negative amortization, the maximum principal of $11,500 would be reached at the 30th payment. The new fully amortizing principal and interest payment would be $101.70 starting with the 30th payment. To see what your payment might be based upon this example, divide your mortgage amount by $10,000; then multiply the monthly payment by that amount. (For example, the initial monthly payment for a mortgage amount of $100,000 would be: $100,000 divided by $10,000 = 10; 10 x $32.16 = $321.60.)

*This is an interest rate that was in effect in March 2006.

Figure 3c (p.3, partial view):
http://www.thornburgmortgage.com/thornburg/portals/0/Lend_Media/1MonthLIBOROptionARMDisclosure.pdf
Historical Example: The example below shows how the ANNUAL PERCENTAGE RATE and the minimum payments for a single $10,000.00 credit advance would have changed based on changes in the Index over the past 15 years. The Index values are from the 1st business day of November of each year. While only one payment per year is shown, payments may have varied during each year.

The table assumes that no additional credit advances were taken and that only the minimum payment was made. It does not necessarily indicate how the Index or your payments would change in the future. It does not include an initial discounted rate and assumes no Locks.

<table>
<thead>
<tr>
<th>Year</th>
<th>Index (Percent)</th>
<th>Margin (Percent)</th>
<th>ANNUAL PERCENTAGE RATE</th>
<th>Monthly Payment (Dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>8.000</td>
<td>0.000</td>
<td>8.000</td>
<td>67.95</td>
</tr>
<tr>
<td>1992</td>
<td>6.000</td>
<td>0.000</td>
<td>6.000</td>
<td>50.96</td>
</tr>
<tr>
<td>1993</td>
<td>6.000</td>
<td>0.000</td>
<td>6.000</td>
<td>50.96</td>
</tr>
<tr>
<td>1994</td>
<td>7.750</td>
<td>0.000</td>
<td>7.750</td>
<td>65.82</td>
</tr>
<tr>
<td>1995</td>
<td>8.750</td>
<td>0.000</td>
<td>8.750</td>
<td>74.32</td>
</tr>
<tr>
<td>1996</td>
<td>8.250</td>
<td>0.000</td>
<td>8.250</td>
<td>70.07</td>
</tr>
<tr>
<td>1997</td>
<td>8.500</td>
<td>0.000</td>
<td>8.500</td>
<td>72.19</td>
</tr>
<tr>
<td>1998</td>
<td>8.000</td>
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<tr>
<td>1999</td>
<td>8.250</td>
<td>0.000</td>
<td>8.250</td>
<td>70.07</td>
</tr>
<tr>
<td>2000</td>
<td>9.500</td>
<td>0.000</td>
<td>9.500</td>
<td>200.00</td>
</tr>
<tr>
<td>2001</td>
<td>5.500</td>
<td>0.000</td>
<td>5.500</td>
<td>200.00</td>
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<tr>
<td>2002</td>
<td>4.750</td>
<td>0.000</td>
<td>4.750</td>
<td>200.00</td>
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<tr>
<td>2003</td>
<td>4.000</td>
<td>0.000</td>
<td>4.000</td>
<td>200.00</td>
</tr>
<tr>
<td>2004</td>
<td>4.750</td>
<td>0.000</td>
<td>4.750</td>
<td>200.00</td>
</tr>
<tr>
<td>2005</td>
<td>7.000</td>
<td>0.000</td>
<td>7.000</td>
<td>200.00</td>
</tr>
</tbody>
</table>

* This is a margin we have used recently; your margin may be different.

Figure 4 (partial view):  
http://www.sandyspringbank.com/ab_equity_disclosure.htm
### GOOD FAITH ESTIMATE

Lender:  
Address:  
Applicant(s):  
Property Address:  

Sales Price:  
Base Loan Amount:  
Total Loan Amount:  
Interest Rate:  
Type of Loan:  
Preparation Date:  
Loan Number:  

The information provided below reflects estimates of the charges which you are likely to incur at the settlement of your loan. The fees listed are estimates - actual charges may be more or less. Your transaction may not involve a fee for every item listed. The numbers listed beside the estimates generally correspond to the numbered lines contained in the HUD-1 or HUD-1A settlement statement which you will be receiving at settlement. The HUD-1 or HUD-1A settlement statement will show you the actual cost for items paid at settlement.

<table>
<thead>
<tr>
<th>#00</th>
<th>ITEMS PAYABLE IN CONNECTION WITH LOAN</th>
<th>#000</th>
<th>TITLE CHARGES</th>
</tr>
</thead>
</table>
| 001 | Obligation Fee @ % + $               | 1101 | Closing or Escrow Fee | $  
| 002 | Discount Fee @ % + $                 | 1102 | Abstract or Title Search | $  
| 003 | Appraisal Fee                        | 1103 | Title Examination | $  
| 004 | Credit Report                        | 1104 | Document Preparation Fee | $  
| 005 | Lender's Inspection Fee              | 1105 | Notary Fee | $  
| 006 | Mortgage Insurance Application Fee   | 1106 | Title Insurance | $  
| 007 | Assumption Fee                       | 1107 | Attorney's Fee | $  
| 008 | Mortgage Broker Fee                  | 1108 | | $  
| 010 | Tax Related Service Fee              | 1109 | | $  
| 011 | Application Fee                      | 1110 | | $  
| 012 | Commitment Fee                       | 1111 | | $  
| 013 | Lender's Rate Lock-In Fee            | 1112 | | $  
| 014 | Processing Fee                       | 1113 | | $  
| 015 | Underwriting Fee                     | 1114 | | $  
| 016 | Wire Transfer Fee                    | 1115 | | $  

1200 | GOVERNMENT RECORDING AND TRANSFER CHARGES:  
1201 | Recording Fee | $  
1202 | City/County Tax/Stamps | $  
1203 | State Tax/Stamps | $  
1204 | Intangibles Tax | $  
1205 | | $  

<table>
<thead>
<tr>
<th>#200</th>
<th>ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>021</td>
<td>Interest</td>
</tr>
<tr>
<td>022</td>
<td>Mortgage Insurance Premium</td>
</tr>
<tr>
<td>023</td>
<td>Hazard Insurance Premium</td>
</tr>
</tbody>
</table>

CURRENT INTEREST RATES

Here are all the programs available, with various points and rates. Choose a program and click "Loan application" below to start a new account. You can also use our email rate alert feature if you would like to be notified when our interest rates match your preferences. Rates and points are only available through Wachovia Mortgage's Internet Channel. Rates and points are only available through Wachovia Mortgage's Internet Channel.

<table>
<thead>
<tr>
<th>Program</th>
<th>Principal and Interest Payment</th>
<th>Rate</th>
<th>Points</th>
<th>Origination Fee</th>
<th>APR</th>
<th>Closing Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 Point Programs (rates nearest to 2 points)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30 Year Fixed</td>
<td>$3,104</td>
<td>5.875%</td>
<td>2.00%</td>
<td>0.750%</td>
<td>0.274%</td>
<td>$27,500*</td>
</tr>
<tr>
<td>30 Year ARM</td>
<td>$2,600</td>
<td>5.000%</td>
<td>1.50%</td>
<td>0.750%</td>
<td>7.025%</td>
<td>$24,170*</td>
</tr>
<tr>
<td>5 Year ARM</td>
<td>$2,040</td>
<td>5.125%</td>
<td>1.00%</td>
<td>0.750%</td>
<td>7.255%</td>
<td>$20,290*</td>
</tr>
<tr>
<td>1 Point Programs (rates nearest to 1 point)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30 Year Fixed</td>
<td>$3,291</td>
<td>6.125%</td>
<td>1.00%</td>
<td>0.750%</td>
<td>0.456%</td>
<td>$22,780*</td>
</tr>
<tr>
<td>30 Year ARM</td>
<td>$4,994</td>
<td>5.750%</td>
<td>0.625%</td>
<td>0.750%</td>
<td>0.112%</td>
<td>$21,605*</td>
</tr>
<tr>
<td>5 Year ARM</td>
<td>$3,382</td>
<td>5.250%</td>
<td>1.00%</td>
<td>0.750%</td>
<td>7.002%</td>
<td>$21,500*</td>
</tr>
<tr>
<td>0 Point Programs (rates nearest to 0 points)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30 Year Fixed</td>
<td>$3,900</td>
<td>6.375%</td>
<td>No Points</td>
<td>0.750%</td>
<td>0.250%</td>
<td>$18,577*</td>
</tr>
<tr>
<td>30 Year ARM</td>
<td>$4,557</td>
<td>6.000%</td>
<td>No Points</td>
<td>0.750%</td>
<td>0.220%</td>
<td>$18,411*</td>
</tr>
<tr>
<td>5 Year ARM</td>
<td>$3,151</td>
<td>5.750%</td>
<td>0.125%</td>
<td>0.750%</td>
<td>7.137%</td>
<td>$17,052*</td>
</tr>
<tr>
<td>5 Year ARM</td>
<td>$3,104</td>
<td>5.875%</td>
<td>No Points</td>
<td>0.750%</td>
<td>0.245%</td>
<td>$16,990*</td>
</tr>
</tbody>
</table>

Figure 7 (partial view): [http://mortgagedirect.wachovia.com](http://mortgagedirect.wachovia.com)
Table 2. IndyMac Bank: Subprime Wholesale Interest Rates continued

<table>
<thead>
<tr>
<th>Level</th>
<th>2/6 LIBOR</th>
<th>3/1 Treasury</th>
<th>2/6 &amp; 30-Yr Fixed</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rates based on 2-YR PP-30 BE</td>
<td>Rates based on 3-YR PP-30 BE</td>
<td>Rates based on 3-YR PP-30 BE</td>
</tr>
<tr>
<td>Rates</td>
<td>Base</td>
<td>Margin</td>
<td>Rates</td>
</tr>
<tr>
<td>Levels</td>
<td>100</td>
<td>101</td>
<td>102</td>
</tr>
<tr>
<td>Level 600-699</td>
<td>85</td>
<td>55</td>
<td>6.250</td>
</tr>
<tr>
<td>800-899</td>
<td>80</td>
<td>55</td>
<td>6.250</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rate &amp; Margin Adjustments</th>
<th>Rate</th>
<th>Margin</th>
<th>Prepay Penalty Rate Adjustments</th>
<th>2-YR Fixed</th>
<th>30-Yr Fixed/3/1 ARM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited Doc—Based on Full Doc</td>
<td>0.250</td>
<td>0.750</td>
<td>0 Years Prepay Penalty</td>
<td>0.500</td>
<td>0.750</td>
</tr>
<tr>
<td>No Ratio—Based on Stated Income</td>
<td>0.375</td>
<td>0.750</td>
<td>1 Years Prepay Penalty</td>
<td>0.625</td>
<td>0.750</td>
</tr>
<tr>
<td>2nd Home</td>
<td>0.500</td>
<td>0.750</td>
<td>2 Years Prepay Penalty</td>
<td>0.750</td>
<td>0.750</td>
</tr>
<tr>
<td>3rd Home</td>
<td>0.750</td>
<td>0.750</td>
<td>3 Years Prepay Penalty</td>
<td>0.875</td>
<td>0.750</td>
</tr>
<tr>
<td>Non Owner Occupied</td>
<td>0.750</td>
<td>0.750</td>
<td>4 Years Prepay Penalty</td>
<td>0.875</td>
<td>0.750</td>
</tr>
<tr>
<td>Credit Score Rate Adjustments</td>
<td>Credit Score 620-640</td>
<td>(0.125)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit Score 641-660</td>
<td>(0.250)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit Score 661 &amp; up</td>
<td>(0.500)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Borrower Paid All Rate Adjustments</td>
<td>0.250</td>
<td>0.250</td>
<td>UY 0.10</td>
<td>(0.375)</td>
<td></td>
</tr>
<tr>
<td>Low-rate Condo</td>
<td>0.250</td>
<td>0.250</td>
<td>UY 0.10</td>
<td>(0.375)</td>
<td></td>
</tr>
<tr>
<td>Loan Amount &gt; $150K to $500K</td>
<td>0.250</td>
<td>0.250</td>
<td>Max Price/Yield Spread</td>
<td>101.0</td>
<td></td>
</tr>
<tr>
<td>Adj from FND, F30/15, or F45</td>
<td>0.125</td>
<td>0.125</td>
<td>Max Price with 3-YR PPP</td>
<td>101.0</td>
<td></td>
</tr>
<tr>
<td>Max Price with 1-YR PPP</td>
<td>101.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Max Price with 3-YR PPP</td>
<td>102.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Figure 8: Alan M. White, Risk-Based Mortgage Pricing: Present and Future Research, 15 HOUSING POL’Y DEBATE 503, 5011 (2004).
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Figure 9: https://new-e-mits.indymacb2b.com/login/login.asp?goto=eratesheets&msg=rates
Figure 10: