

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket ID OCC-2008-0007]

FEDERAL RESERVE SYSTEM

[Docket No. OP-1292]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[Docket No. OTS-2008-0003]

NATIONAL CREDIT UNION ADMINISTRATION

Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA) (collectively, the Agencies).

ACTION: Final Guidance – Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products

SUMMARY: The Agencies are publishing four documents that set forth Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products. The illustrations are intended to assist institutions in implementing the consumer protection portion of the Interagency Statement on Subprime Mortgage Lending adopted on July 10, 2007, and in providing information to consumers on subprime adjustable rate mortgage (ARM) products as recommended by that interagency statement. The illustrations are not model forms and institutions may choose not to use them.

EFFECTIVE DATE: [Insert Date of Publication in Federal Register]

FOR FURTHER INFORMATION CONTACT:

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Board: Kathleen C. Ryan, Counsel, or Jamie Z. Goodson, Attorney, Division of Consumer and Community Affairs, (202) 452-3667. For users of Telecommunication Device for Deaf only, call (202) 263-4869.

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OTS: Glenn Gimble, Senior Project Manager, Compliance and Consumer Protection Division, (202) 906-7158, or Suzanne McQueen, Consumer Regulations Analyst, Compliance and Consumer Protection Division, (202) 906-6459.

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SUPPLEMENTARY INFORMATION:

I. Background

On March 8, 2007, the Agencies published the Interagency Statement on Subprime Mortgage Lending (Subprime Statement) for comment. 72 FR 10533 (March 8, 2007). After carefully reviewing and considering all comments received, the Agencies published the Subprime Statement (applicable to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings institutions and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions) in final form on July 10, 2007. 72 FR 37569 (July 10, 2007).

The Subprime Statement sets forth recommended practices to ensure that consumers have clear and balanced information about certain subprime adjustable rate mortgage products during the product selection process, not just upon submission of an application or at consummation of the loan. This information should address the relative benefits and risks of these products and describe their costs, terms, features, and risks to the borrower.

Some industry group commenters on the proposed Subprime Statement asked the Agencies to provide uniform disclosures for these products, or to publish illustrations of the consumer information contemplated by the Subprime Statement similar to those previously proposed by the Agencies in connection with nontraditional mortgage products. (These illustrations were subsequently revised and published in final form.¹) The Agencies determined that illustrations of the consumer information contemplated by the Subprime Statement may be useful to institutions as they seek to ensure that consumers receive the information they need

¹ Illustrations of Consumer Information for Nontraditional Mortgage Products, 72 FR 31825 (June 8, 2007).

about the material features of these loans. On August 14, 2007, the Agencies published for comment two Proposed Illustrations of Consumer Information for Subprime Mortgage Lending (Proposed Illustrations). 72 FR 45495 (Aug. 14, 2007).

The two Proposed Illustrations consisted of (1) a narrative explanation of some of the key features of certain ARM loans that are identified in the Subprime Statement, including payment shock, responsibility for taxes and insurance, prepayment penalties,² balloon payments, and increased costs associated with stated income or reduced documentation loans, and (2) a chart with numerical examples that is designed to show the potential consequences of payment shock in a concrete, readily understandable manner for a loan structured with a discounted interest rate for the first two years.

The Agencies requested comment on all aspects of the Proposed Illustrations. Specifically, commenters were asked to address whether the illustrations, as proposed, would be useful to institutions, including community banks, seeking to implement the “Consumer Protection Principles” portion of the Subprime Statement, or whether changes should be made. The Agencies also encouraged specific comment on whether the illustrations, as proposed, would be useful in promoting consumer understanding of the risks and material terms of certain ARM products, as described in the Subprime Statement, or whether changes should be made. Additionally, the Agencies sought comment on whether the information in the Proposed Illustrations is set forth in a clear manner and format; whether these illustrations or a modified form should be adopted by the Agencies; and whether additional illustrations relating to certain ARM products would be useful to consumers and institutions. Finally, the Agencies requested information on any consumer testing that commenters may have conducted in connection with comparable disclosures.

² Federal credit unions are prohibited from charging prepayment penalties. 12 CFR 701.21.

After considering the comments received, the Agencies are now issuing final illustrations of consumer information for certain subprime ARMs. The Subprime Statement recommends that communications with consumers, including advertisements, oral statements, and promotional materials, provide clear and balanced information about the relative benefits, costs, terms, features, and risks of certain ARM products to the borrower. This includes information about the risk of payment shock, the ramifications of prepayment penalties, balloon payments, and a lack of escrow for taxes and insurance, and any pricing premium associated with a stated income or reduced documentation loan program.

Use of the illustrations is entirely voluntary. Accordingly, there is no Agency requirement or expectation that institutions must use the illustrations in their communications with consumers. Institutions seeking to follow the recommendations set forth in the Subprime Statement may, at their option, elect to:

- Use the illustrations;
- Provide information based on the illustrations, but expand, abbreviate, or otherwise tailor any information in the illustrations as appropriate to reflect, for example:
 - the institution's product offerings, such as by deleting information about loan products and loan terms not offered by the institution and by revising the illustrations to reflect specific terms currently offered by the institution;
 - the consumer's particular loan requirements or qualifications;
 - current market conditions, such as by changing the loan amounts, interest rates, and corresponding payment amounts to reflect current local market circumstances;

- other material information relating to the loan consistent with the Subprime Statement; and
- the results of consumer testing of the illustrations or comparable disclosures; or
- Provide the information described in the Subprime Statement, as appropriate, in an alternate format.

To assist institutions that wish to use the illustrations, the Agencies will be posting each of the illustrations on their respective websites in a form that can be downloaded and printed for easy reproduction. The Agencies also will develop and post Spanish-language versions of the illustrations on their respective websites. Additionally, in response to concerns that the interest rates used in Illustrations Nos. 2A, 2B, and 2C may become outdated with changes in market interest rates – and consistent with the Agencies’ intention, expressed above, that the illustrations may be modified to reflect, among other things, current market conditions – the Agencies also will be posting on their respective websites a template that can be used by institutions that wish to modify the information presented in these illustrations to reflect more current interest rates (and corresponding payment amounts).

II. Overview of the Comments

Collectively, the Agencies received approximately 25 comment letters on the proposal, including comments from one federal regulatory agency, a group of three associations of state banking and consumer protection agencies, six financial institutions, ten trade organizations, two community organizations, and five individuals.

Most commenters encouraged the Agencies to adopt the illustrations. These commenters stated that the illustrations would be useful to financial institutions, including community banks,

seeking to implement the consumer protection principles of the Subprime Statement. At least one commenter also noted that the illustrations would help reduce implementation costs and compliance burden.

Several trade organizations supported making use of the illustrations voluntary. These commenters also urged the Agencies to notify their examiners that use of the illustrations is not required to show compliance with the Subprime Statement. One of these commenters stated that in developing the illustrations the Agencies have appropriately balanced the need for institutions to provide meaningful disclosures and the need to avoid unnecessary burdens. On the other hand, one community organization advocated that use of the illustrations should be made mandatory to prevent consumer confusion due to lack of uniform disclosures from lender to lender.

Many commenters suggested that the Proposed Illustrations could confuse consumers about whether the illustrations are describing features of subprime ARMs generally or, instead, describing the mortgage they are actually considering or being offered. These commenters suggested modifying the illustrations by revising statements that appear specific to a particular borrower and loan product. Other commenters, however, suggested modifying the illustrations so that they would be based on the actual loan product or product choices lenders will offer to the particular applicant, and include more loan-specific details.

Commenters also suggested changes to make the illustrations more accurately reflect the actual terms of products prevalent in the market. For example, it was noted that the illustrations focused on subprime ARM products structured with a discounted interest rate for the first two years. Due to recent market developments, such products have become uncommon, and have

been replaced, to some extent, by products with somewhat longer discounted initial interest rate periods.

Finally, commenters made a number of suggestions to change the wording, format, or content of the illustrations in order to improve the accuracy, clarity, or usefulness of the illustrations for consumers.

III. Final Illustrations

After carefully considering all of the comments received, the Agencies have decided to publish the proposed illustrations in final form, with some modifications.³ Additionally, the Agencies believe that issuing these materials as nonmandatory illustrations will provide institutions with the flexibility needed to tailor the materials to their own circumstances and consumer needs.

In response to commenter concerns, the Agencies have made three sets of changes to the proposed illustrations, as described more fully below. The first change relates to the language and format of Illustration No. 1. The Agencies have modified this illustration so it clearly will be a general description of the features of the products covered by the Subprime Statement, rather than a loan-specific disclosure. Second, the Agencies have included additional versions of Illustration No. 2 to provide institutions with illustrations reflecting products that may be more prevalent in the market, and to show how institutions might provide this information when they offer multiple products subject to the Subprime Statement. Finally, the Agencies have adopted a number of wording and format changes to improve the readability and usefulness of the illustrations for consumers, and to make it easier for consumers to understand the key risks of the products covered by the Subprime Statement.

³ The Agencies are using a different title for this final guidance than for the proposed guidance to reflect more closely the types of mortgage products covered by the Subprime Statement.

A. Proposed Illustration No. 1

As noted above, several commenters suggested that Illustration No. 1 should generally describe features found in the subprime ARM products covered by the Subprime Statement. Given that the Subprime Statement calls for early delivery – during the product selection process – of the consumer information contemplated in the Statement, the Agencies agree that it could be inappropriate and confusing for Illustration No. 1 to appear to set forth specific loan terms. At this stage, consumers have not yet selected a specific loan, and institutions likely will not have performed the credit underwriting necessary to determine all of the terms that may be offered to the consumer. In view of these uncertainties, and in light of the fact that subprime ARMs may include various combinations of the risks and features highlighted in the Subprime Statement, it would not be possible for this narrative description to convey loan-specific information in a way that would be accurate or relevant for all consumers. For these reasons, attempting to include loan-specific information would frustrate one of the Agencies’ primary goals in issuing these illustrations: namely, to create a set of documents that institutions can use to satisfy the expectations outlined in the Subprime Statement.⁴

Accordingly, in order to make clear that this illustration is simply a generic description of key risks and features that may be found in the products covered by the Subprime Statement, and to improve readability and usefulness, the Agencies have made substantial changes to proposed Illustration No. 1, and have adopted, to a large extent, the format used in the Agencies’ nontraditional mortgage product illustrations.⁵ Most significantly, the document has been revised and reformatted to emphasize the risk of payment shock present in all products covered by the Subprime Statement, as opposed to other features (such as prepayment penalties) that may

⁴ In this regard, the Agencies note that institutions will continue to have obligations under the Truth in Lending Act, Real Estate Settlement Procedures Act, and other laws to provide consumers with timely, loan-specific information.

⁵ Illustrations of Consumer Information for Nontraditional Mortgage Products, 72 FR 31825 (June 8, 2007).

(or may not) be found in any particular loan.⁶ These other features are now described under a general heading, “Additional Information.” The Agencies also believe that distinguishing between the inherent and potential risks of these products, and formatting the document accordingly, helps to make the document easier to use and understand. The Agencies also have revised the language in the subject matter headings of the “Additional Information” portion of the document. These changes are designed to conform to the approach used in the nontraditional mortgage product illustrations and to clarify that the features described therein are not necessarily included in the loan to be offered to the consumer.

The Agencies also adopted several suggestions from commenters to place more emphasis on the nature of the risks associated with obtaining a subprime ARM product of the type covered by the Subprime Statement, and to focus consumers’ attention on those risks. For example, the Agencies have added language directing consumers not to assume that they will be able to refinance their ARM to a lower rate in the future. The final illustration also states that consumers “need to know” whether the monthly payment includes taxes and insurance, whether their loan would have a prepayment penalty or balloon payment, and whether obtaining a “full documentation” loan would be more cost-effective.

Other recommendations were adopted by the Agencies to improve the clarity or usefulness of the document for consumers. For example, Illustration No. 1 was modified to reflect interest rate indexes more likely to be used by lenders in the current market.

The Agencies decided not to adopt a number of specific suggestions made by commenters. Some of these suggestions were largely duplicative of information already contained in the document, or otherwise would have made the document too lengthy and less

⁶ The title of this illustration also has been revised, in response to commenter suggestions, to stress that the document includes important facts about any adjustable rate mortgage with a reduced initial interest rate.

consumer-friendly. Other comments would have provided substantive advice to consumers about particular features and terms, and were inconsistent with the purpose of the illustration to provide important information in an objective, balanced manner. One commenter representing the credit union industry suggested deleting the reference to prepayment penalties in Illustration No. 1 on the grounds that federal credit unions are not permitted to charge such penalties. The Agencies did not adopt this suggestion, however, because the illustrations are designed for the use of all institutions supervised by any of the Agencies. As noted above, institutions may tailor the information in the illustrations as appropriate to reflect, for example, their own product offerings. Other suggested changes that were not adopted would not, in the Agencies' view, have enhanced the clarity or usefulness of the illustration for consumers.

B. Proposed Illustration No. 2

After reviewing and considering the comments, the Agencies have retained Proposed Illustration No. 2 – a chart comparing payment obligations on a fixed rate loan and an ARM with a discounted interest rate for the first two years – but have re-designated the illustration as Illustration No. 2A. In response to the comments and market changes, the Agencies also have included two additional versions of Proposed Illustration No. 2 for institutions to consider using. Comments on Illustration No. 2, as well as external data reviewed, indicate that subprime ARM products structured with a discounted interest rate for the first five years may have become more prevalent in the current market than similar products structured with a discounted interest rate for the first two years. Accordingly, the Agencies have added a similar chart, designated as Illustration No. 2B, that compares payment obligations on a fixed rate loan and an ARM with a discounted interest rate for the first five years. Institutions may believe that Illustration No. 2B is more helpful than Illustration No. 2A to consumers considering loans whose initial rate remains

in effect for a longer period of time. In addition, the Agencies have added a third chart, designated as Illustration No. 2C, that compares payment obligations on three products: a fixed rate loan; an ARM with a discounted interest rate for the first two years; and an ARM with a discounted rate for five years. Institutions that would like to present information about multiple products they offer on a single page, rather than providing a separate illustration for each product, may find this third chart to be useful.⁷ The Agencies also adopted a number of minor wording changes, including changes in the left column of the illustration to clarify that the interest rate conditions specified therein are specifically referring to movement in index interest rates, and not the interest rate increases required by the terms of the subprime ARM loan. The Agencies also changed the assumed interest rate increase in the final row of the left column to be more consistent with the illustration's assumptions about product structure, and thereby less likely to produce consumer confusion. The Agencies did not adopt some suggestions made by commenters because they would require the provision of loan-specific information that could not feasibly or accurately be presented in the early product selection process. However, as noted above, institutions that wish to modify the information presented in these illustrations will be able to access relevant templates on the respective websites of the Agencies and insert more loan-specific information. Some recommendations also were not adopted because, on balance, they would unreasonably increase or duplicate the information already included or would not otherwise appear to improve the clarity or usefulness of the information presented for consumers.

The final illustrations appear below.

⁷ Illustrations Nos. 2A, 2B, and 2C reflect typical interest rates for these products at the time the Agencies issued the Subprime Statement, and embody other assumptions about typical features of these products. For example, they reflect assumptions that: the fully-indexed rate is 4.5 percentage points higher than the initial rate (based on an initial index rate of 5.5 percent and a margin of 6 percent); the first interest rate adjustment cannot exceed 3 percentage points; subsequent interest rate adjustments may not exceed 1.5 percentage points; and the applicable interest rate may never be more than 6 percentage points higher than the initial rate.

Illustration 1

Important Facts About Adjustable Rate Mortgages with a Reduced Initial Interest Rate

Whether you are buying a house or refinancing your mortgage, this information can help you decide if an adjustable rate mortgage (ARM) is right for you. ARMs can be complicated, and it is important for you to understand the features and risks of these loans. **If you do not understand how ARMs work, you should not sign any ARM loan contracts, and you might want to consider other loans, including fixed rate loans.**

With an ARM, the interest rate and monthly payment on the loan is not fixed and may increase.

- The interest rate changes over time according to a formula – typically, a base interest rate (index rate) plus a certain percent (margin).
- For example, the rate could equal the one year U.S. Treasury rate plus 4 percent or the rate of the 6 month “LIBOR” index plus 3 percent.
- If the base interest rate increases, your interest rate and monthly payment will also increase.

If an ARM has a reduced interest rate for an initial period – for example, the first 2 years or first 5 years of the loan – the rate and the monthly payment may increase significantly. When that initial period is over:

- The interest rate and monthly payment may increase significantly even if the index rate stays the same.
- The interest rate and monthly payment will increase even more if the index rate increases.

Do not assume that you will be able to refinance an ARM to a lower rate in the future.

Additional Information

► **Payments for taxes and insurance.** In some mortgages, your monthly payment includes both principal and interest and an “escrow” amount to cover real estate taxes and insurance. Your lender then pays your taxes and insurance out of these escrow funds. In other mortgages, your monthly payment covers only principal and interest, and you are responsible for budgeting for and paying real estate taxes and insurance premiums when the bills arrive. These costs can be substantial. When you are comparing mortgages, or deciding whether you can afford one, you need to know whether or not the monthly payment includes an amount to cover taxes and insurance.

► **Prepayment penalties.** Some mortgages require you to pay a large prepayment penalty if you sell your home or refinance during the first few years of the loan – which you may need to do if your interest rate, and therefore your payment, is about to increase significantly, or if your circumstances change and you must sell your home before the prepayment period expires. The amount of the penalty will be added to your loan payoff amount. A prepayment penalty can make it difficult, or very expensive, to sell your home or refinance. You need to know whether your loan has a prepayment penalty, how much it is, and how long it will apply.

► **Balloon payments.** Most mortgages are set up so that you pay off the loan gradually by the monthly payments that you make over the loan term (for example, 30 years). Some mortgages, however, are set up with “balloon payments” – you make the same monthly payments that you would for a 30-year loan, but after a shorter period of time (for example, 10 years), you will owe one large final payment of the entire remaining balance of the loan. If you are unable to make the balloon payment when it is due, you would need to refinance your loan – or sell your home. You need to know whether your loan has a balloon payment.

► **No Doc/Low Doc Loans.** “Reduced documentation” or “stated income” loans usually have higher interest rates or other costs compared to “full documentation” loans that are available if you document your income, assets, and liabilities. These higher costs can be substantial. You need to know whether you would save money with a “full documentation” loan.

Illustration 2A

SAMPLE MORTGAGE COMPARISON

(Not actual loans available)

Sample Loan Amount \$200,000 – 30-Year Term – Interest Rates For Example Purposes Only

	Fixed Rate Mortgage	Reduced Initial Rate “2/28” ARM 7% for two years, then adjusting to variable rate based on index interest rate, subject to annual rate caps; 10% rate in Year 3; 11.5% rate in Year 4; 13% maximum ARM rate in Years 5-30
	7.5%	
REQUIRED MONTHLY PAYMENTS (includes \$200 per month for real estate tax and insurance escrow)		
Years 1-2	\$1,598	\$1,531
Year 3 – even if index interest rate does not change	\$1,598	\$1,939
Year 4 – even if index interest rate does not change	\$1,598	\$2,152
Year 5 – if index interest rate rises 1.5% (maximum ARM rate)	\$1,598	\$2,370

Illustration 2B

SAMPLE MORTGAGE COMPARISON

(Not actual loans available)

Sample Loan Amount \$200,000 – 30-Year Term – Interest Rates For Example Purposes Only

	Fixed Rate Mortgage	Reduced Initial Rate “5/25” ARM 7% for five years, then adjusting to variable rate based on index interest rate, subject to annual rate caps; 10% rate in Year 6; 11.5% rate in Year 7; 13% maximum ARM rate in Years 8-30
	REQUIRED MONTHLY PAYMENTS (includes \$200 per month for real estate tax and insurance escrow)	
Years 1-5	\$1,598	\$1,531
Year 6 – even if index interest rate does not change	\$1,598	\$1,910
Year 7 – even if index interest rate does not change	\$1,598	\$2,109
Year 8 – if index interest rate rises 1.5% (maximum ARM rate)	\$1,598	\$2,311

Illustration 2C

SAMPLE MORTGAGE COMPARISON

(Not actual loans available)

Sample Loan Amount \$200,000 – 30-Year Term – Interest Rates For Example Purposes Only

	Fixed Rate Mortgage 7.5%	Reduced Initial Rate “5/25” ARM 7% for five years, then adjusting to variable rate based on index interest rate, subject to annual rate caps; 10% rate in Year 6; 11.5% rate in Year 7; 13% maximum ARM rate could apply in Years 8-30	Reduced Initial Rate “2/28” ARM 7% for two years, then adjusting to variable rate based on index interest rate, subject to annual rate caps; 10% rate in Year 3; 11.5% rate in Years 4-7; 13% maximum ARM rate could apply in Years 5-30
	REQUIRED MONTHLY PAYMENTS If Index Interest Rate Stays the Same (includes \$200 per month for real estate tax and insurance escrow)		
Years 1-2	\$1,598	\$1,531	\$1,531
Year 3	\$1,598	\$1,531	\$1,939
Year 4	\$1,598	\$1,531	\$2,152
Year 5	\$1,598	\$1,531	\$2,152
Year 6	\$1,598	\$1,910	\$2,152
Year 7	\$1,598	\$2,109	\$2,152
Year 8 – if index interest rate rises 1.5% (maximum ARM rate)	\$1,598	\$2,311	\$2,359

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “ILLUSTRATIONS OF CONSUMER INFORMATION FOR HYBRID ADJUSTABLE RATE MORTGAGE PRODUCTS”]

Dated: April __, 2008

John C. Dugan,
Comptroller of the Currency

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “ILLUSTRATIONS OF CONSUMER INFORMATION FOR HYBRID ADJUSTABLE RATE MORTGAGE PRODUCTS”]

By order of the Board of Governors of the Federal Reserve System, April __, 2008.

Jennifer J. Johnson
Secretary of the Board

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “ILLUSTRATIONS OF CONSUMER INFORMATION FOR HYBRID ADJUSTABLE RATE MORTGAGE PRODUCTS”]

Dated at Washington, D.C., the __ day of April, 2008.

By order of the Federal Deposit Insurance Corporation

Robert E. Feldman,
Executive Secretary

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “ILLUSTRATIONS OF CONSUMER INFORMATION FOR HYBRID ADJUSTABLE RATE MORTGAGE PRODUCTS”]

Dated: April __, 2008
By the Office of Thrift Supervision

John Reich,
Director

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “ILLUSTRATIONS OF CONSUMER INFORMATION FOR HYBRID ADJUSTABLE RATE MORTGAGE PRODUCTS”]

By the National Credit Union Administration on April 25, 2008.

JoAnn M. Johnson,
Chairman