K&L UPDATE

Mortgage Banking Commentary

JANUARY 22, 2001

RECENT PREDATORY LENDING DEVELOPMENTS

I. MASSACHUSETTS' DIVISION OF BANKS POSTPONES IMPLEMENTATION OF NEW HIGH COST HOME LOAN REGULATIONS TO MARCH 22, 2001

On August 3, 2000, the Massachusetts Division of Banks (the "DOB") issued proposed high cost home loan regulations to address and further regulate certain practices identified as "predatory lending." As set forth in our September 7, 2000 Mortgage Banking Commentary, the majority of these proposed amendments affect the DOB's regulations implementing Massachusetts' Truth-in-Lending Act (the "Massachusetts TILA"). The proposed amendments to Section 32.32 of the regulations to the Massachusetts TILA ("Massachusetts Section 32") modify and/or add high cost home loan provisions to these regulations. Additionally, to ensure that the proposed high cost home loan protections found in Massachusetts Section 32 apply equally to all high rate mortgage lenders operating in Massachusetts, the DOB also added the Unfair and Deceptive Practices in Consumer Transaction regulations ("Part 40") that apply broadly to basically any entity not subject to Massachusetts Section 32 and, in fact, mirror the provisions contained in Massachusetts Section 32. The proposed regulations also amend the DOB's regulations to the Mortgage Lenders and Mortgage Brokers Act (the "Mortgage Act"). Such amendments provide that it will be a prohibited act or practice for Mortgage Act licensees to (i) make or broker Massachusetts Section 32 high cost mortgage loans that violate Massachusetts Section 32's disclosure requirements, loan limitations, prohibited acts and practices provisions, and unfair high cost loan practice provisions; or (ii) purchase or make a high cost loan originated by a mortgage broker that violates the high cost provisions in Massachusetts Section 32 and (i) above. Mortgage Act licensees that violate such prohibitions risk license suspension or revocation. (The ambiguous language of the amendments to the Mortgage Act raises certain issues that will need to be clarified. The Mortgage Act does not require a license to purchase closed loans. Moreover, the penalty for licensees purchasing loans that violate Massachusetts Section 32 only extends to the purchase of loans originated by a mortgage broker. As a mortgage broker cannot close loans in its name with only a mortgage broker's license, arguably the penalty for licensees purchasing loans from brokers is intended to reach loan packages and not closed loans).

Public hearings were held to discuss the DOB's proposed regulations on September 19th thru 21st, 2000. According to the DOB, approximately 80 people attended these three hearings, and 25 individuals presented oral testimony. The DOB also received 26 written comments, three of which were submitted after the comment period closed. After considering the issues that were raised, the DOB filed the final high cost home loan regulations with the State Secretary on December 8, 2000. Although it was originally anticipated that these regulations would take effect on January 22, 2001, the DOB changed the effective date to March 22, 2001 so creditors have

sufficient time to implement the new disclosure requirements and make changes to existing documentation and calculation systems. The DOB also developed a "High Cost Mortgage Loan FAQ" link on their website (at www.state.ma.us/dob.) that posts common questions and answers relating to these amendments.

The final regulations largely reflect those provisions set forth in the DOB's proposed regulations. As reported in our September 7, 2000 Mortgage Banking Commentary, the regulations apply to a "high cost home loan" which is any first- or subordinate-lien, open- or closed-end loan secured by the borrower's principal dwelling in which the (i) APR exceeds by more than 8 percentage points (9 percentage points for junior mortgages) the yield on Treasury securities having comparable periods of maturity; or (ii) total points and fees exceed 5 percent of the total loan amount or $400, whichever is greater. The final regulations, thus, expand the scope of Massachusetts Section 32's "high cost home loan" provisions by (i) lowering the APR for first-lien loans from 10 points to 8 points in excess of the yield on the referenced Treasury securities, and imposing an APR trigger of 9 points in excess of the yield on such Treasury securities for junior mortgage loans; and (ii) reducing the total points and fees trigger by 3 percentage points from the current 8 percent threshold to 5 percent. Also of note is that these final regulations:

- Address 13 "predatory practices" including loan flipping, loan packing, encouraging default, mandatory financing of points and fees, and others.
- Provide that high cost home loans cannot provide for negative amortization, advance payments, or an increase in the interest rate after default. Restrictions apply on balloon payments, prepayment fees, and rebates.
- Require three new consumer high rate loan disclosures, in addition to those disclosures currently required by Massachusetts Section 32.

The final regulations do, however, contain a "bona fide error" defense that was not included in the proposed regulations. Massachusetts Section 32 and Part 40 each provide that there is not a violation if the creditor shows, by a preponderance of the evidence, that the violation was not intentional and resulted from a bona fide error, notwithstanding the maintenance of procedures reasonably adopted to avoid any such error. (See Mass. Regs. Code tit. 209, §§ 32.32(7), 40.08). A bona fide error is defined to include, but is not limited to, clerical, calculation, computer malfunction and programming, and printing errors. An error of legal judgment with respect to a person's obligations is not considered a bona fide error for purposes of this determination.

As the final regulations largely adopt the proposed regulations on which we reported in our September 7, 2000 Mortgage Banking Commentary, we have not reiterated them in this Commentary.

II. DC's PREDATORY LENDING BILL AWAITS CONGRESSIONAL APPROVAL

As we last reported in our November 15, 2000 Mortgage Banking Commentary, the D.C. Council was scheduled to meet on December 5, 2000 to vote on the "Predatory Lending Protections and Mortgage Foreclosure Improvements Act of 2000" (the "D.C. Act" or "Act"). The D.C. Act would, if enacted, (i) change and redefine certain common law and existing case law relating to mortgages, deeds of trust, foreclosure, the conduct of residential lending activities, and the relationships among various persons in real property financing transactions; (ii) codify a loan and foreclosure process; (iii) provide residential property owners with additional protections from

predatory lending practices including an expedited judicial review of certain residential loans for predatory lending practices prior to foreclosure; (iv) require an auditing of all foreclosure sales for compliance with procedures and proper allocation of the foreclosure sale proceeds; and (v) expand the District's real property financing laws to include significant portions of the Restatement of the Law Third of Property (Mortgages) as adopted May 14, 1996 by the American Law Institute.

The D.C. Council met as expected on December 5, 2000, at which Councilmember Charlene Drew Jarvis introduced several amendments to the engrossed version of the D.C. Act. The D.C. Council approved and adopted these amendments in their enrolled version of the Act, which was signed by Mayor Anthony Williams on December 15, 2000. On January 11, 2001, the D.C. Financial Responsibility and Management Assistance Authority also approved the enrolled version of the D.C. Act, which just leaves Congress to approve the D.C. Act before it officially becomes law. Congress has 30 legislative days to approve or disapprove of the Act (a legislative day being any day in which one or both houses of the U.S. Congress are in session and ending upon adjournment), but disapproval is considered rare, and therefore unlikely, because it requires Congress to adopt a joint resolution of disapproval, which then must be signed by the President of the United States. According to Section 1602 of the D.C. Act, the Act will apply to all deeds of trust, mortgages, and other real property lending transactions entered into or having occurred after the earlier of either (i) 150 days after the effective date of the Act; or (ii) 60 days after the effective date of rules promulgated by the Mayor pursuant to Section 1406 of the Act.

Several, but not all, of the amendments made by Councilmember Jarvis related to the D.C. Act's predatory lending provisions. These amendments, as set forth in more detail below, largely concentrated on expanding upon the D.C. Act's (a) exemptions from the term "home loan;" (b) home loan adjusted interest rate calculation; (c) list of predatory lending practices; and (d) penalties/damages provisions.

A. Exemptions from the term "Home Loan"

The D.C. Act addresses predatory lending practices and regulates those who make, broker, arrange, fund, or service "home loans." Home loans are generally defined as loans made to a natural person that are secured by residential owner-occupied real property of 1-4 families and are either (i) in an amount not exceeding the conforming loan size limit for a single-family dwelling established by Fannie Mae and the Federal Home Loan Mortgage Corporation ("Freddie Mac") [currently $252,700]; or (ii) in an amount not exceeding one million dollars and such loan is evidenced by an obligation other than a promissory note, secured by liens on real or personal property in addition to the residential real property and related personal property that is the owner's principal dwelling, or is not a purchase money, finance or improvement loan.

1. *Fannie Mae/Freddie Mac Exception*

The engrossed version of the D.C. Act excluded loans made in conformity with the "highest rating categories" of Fannie Mae and Freddie Mac, at the time the interest rate and origination/discount points and fees were agreed to by the borrower and lender making the loan, regardless of whether the loan was purchased by Fannie Mae or Freddie Mac. The bill was amended to exclude those loans that are "purchased by, delivered to, and made and serviced in conformity with [Fannie Mae/Freddie Mac] underwriting guidelines and servicing procedures." This amendment expands the scope of Fannie Mae and Freddie Mac loan programs that are exempt from the definition of "home loan" and was intended to encourage Fannie Mae and Freddie Mac to enter the subprime

lending area in the District. Thus, any mortgage loan secured only by the borrower's 1-4 family, owner-occupied residence over the Fannie Mae/Freddie Mac conforming loan limits [currently $252,700] or any such loan irrespective of amount purchased by, delivered to, and made and serviced in accordance with Fannie Mae/Freddie Mac guidelines is exempt from the "home loan" definition.

2. *Reverse Mortgage Exception*

The engrossed version of the D.C. Act exempted only those reverse mortgage loans made in conformity with Section 235 of the National Housing Act (home equity conversion mortgages). In an effort to increase the scope of reverse mortgages exempt from the D.C. Act's provisions, the following language was added in addition to the exemption for loans satisfying the National Housing Act's definition of a home equity conversion mortgage: "or a reverse mortgage that fully complies with one of the reverse mortgage approved mortgage loan programs of the U.S. Department of Veteran Affairs, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or any agency of the District."

3. *Federal Programs*

The engrossed version of the D.C. Act exempted a loan made in conformity with a documented loan program of Freddie Mac, Fannie Mae, the Federal Home Loan Bank System, a similar, national, secondary-market making organization regulated or controlled by the United States, or an insured depository institution, whether or not the loan was purchased by one the entities, and had been reviewed and approved by the Mayor. In order to be approved by the Mayor, the program had to have a total dollar amount of not less than $2 million.

The amendment increases the types of organizations that may present subprime lending programs to the Mayor for approval by adding to the list "a residential mortgage originator or purchaser licensed under the Mortgage Lenders and Brokers Act of 1996, effective April 9, 1997, (D.C. Code §§ 26-1001 et seq.) which maintains a net worth exceeding $10 million, or a secondary market purchaser of residential loans which maintains a net worth exceeding $10 million." The amendment also changes the minimum dollar amount of the program necessary for approval from $2 million to a projected total dollar amount of not less than $5 million, unless changed by the Mayor by regulation.

B. Home Loan Adjusted Interest Rate Calculation

1. *Adjustable Rate Mortgage Loans*

The engrossed version of the D.C. Act stated that the home loan adjusted interest rate for adjustable rate mortgage loans was calculated by adding and subtracting the following: (i) the recognized, national or international, adjustable rate mortgage index's annual interest rate on the date the interest rate for the applicable mortgage loan is agreed to by the borrower and person making the mortgage loan; plus (ii) the fixed margin amount stated or referred to in the note; plus (iii) the product of 35 basis points times the origination/discount points and fees charged to any borrower in connection with the origination of the mortgage loan; less (iv) one and one-quarter percent. In order to permit lenders to utilize a federal standard and to streamline and simplify lender calculations, the home loan adjusted interest rate was amended to be equal to the lesser of the annual percentage rate, as defined in Section 225.22 of Title 12 of the Code of Federal Regulations, less one and one-quarter percent, or the percentage determined by the calculation set forth above.

2. *Other Mortgage Loans*

The engrossed version of the D.C. Act stated that the home loan adjusted interest rate for any other mortgage loan was determined by adding and subtracting the annual interest rate agreed to by the borrower and person making the mortgage loan and stated in the note, plus the product of 25 basis points times the origination/discount points and fees charged to any borrower in connection with the origination of the mortgage loan, less one percent. In order to permit lenders to utilize a federal standard and to streamline and simplify lender calculations, the home loan adjusted interest rate was amended to be equal to the lesser of the annual percentage rate, as defined in Section 225.22 of Title 12 of the Code of Federal Regulations, less one percent, or the percentage determined by the calculation set forth above.

C. List of Predatory Lending Practices

1. *Restriction on Financing Origination/Discount Points and Fees*

The engrossed version of the D.C. Act deemed it a predatory act to make a home loan that refinanced a loan secured by the same residential real property to the same borrower which was made 18 months before the home loan was made, that financed, directly or indirectly, any portion of the home loan's origination/discount points and fees or other fees payable to the lender or any third party in excess of the greater of 2% of the new home loan principal amount actually funded or $400 excluding reasonable fees paid to third parties for an appraisal, survey, title examination, and lender's title insurance policy for the home loan. Councilmember Jarvis' amendment permits the Mayor to raise the $400 threshold by regulation. The threshold as set by the Mayor excludes: (i) reasonable charges described in subparagraphs (i), (iii), (iv) and (v) of Section 226.4(c)(7) of Title 12 of the Code of Federal Regulations; and (ii) loan discount points for the purpose of reducing, and which in fact result in a good faith reduction of, the interest rate or time price differential applicable to the new home loan reasonably consistent with established industry customs and practices for secondary mortgage market transactions.

2. *Charges in Bad Faith*

The amendment added language clarifying that there is no presumption that a one percent discount point charged on a loan is unconscionable or has been made in bad faith solely from the fact that the charge does not reduce the interest rate on the home loan by 35 basis points for adjustable rate mortgage loans or 25 basis points for fixed rate mortgage loans.

3. *Balloon Payments for Home Loans of Seven Years or Less*

In order to ensure that borrowers are able to afford the extension of a balloon payment, Section 601(l) of the D.C. Act was amended, in pertinent part, to read as follows:

> The extension option in a home loan must provide the home borrower the option, at the original stated maturity date or at acceleration without a default, to extend the maturity of the home loan without fees or costs to a form: (i) that allows the home borrower to maintain a level of scheduled monthly payments of principal and interest throughout the remaining term of the loan that does not exceed the product of (a) the average dollar amount of all prior scheduled monthly payments of principal and interest from the date of the home loan note until the first stated maturity or

option to accelerate the maturity without a default (excluding the balloon payment), times (b) the sum of (1) one, plus (2) the product of the number of scheduled monthly payments between the date of the home loan note and the date of commencement of the extension option times .0008333; and (ii) under which the home loan will be completely self-amortized and paid by the new maturity date, which may not be later than 35 years after the initial funding of the home loan.

4. *Insurance Premiums*

The engrossed version of the D.C. Act stated that the making of a home loan that finances, directly or indirectly, any single-premium credit life, credit disability, credit property, credit unemployment insurance, or any other life, income or health insurance premiums of the home borrowers was not prohibited or considered predatory if the Mayor approved the insurance plan or program under which the insurance was issued. Councilmember Jarvis' amendment states that the making of a home loan that finances, directly or indirectly, any single-premium credit life, credit disability, credit property, credit unemployment insurance, or any other life, income or health insurance premiums of the home borrower is not prohibited or considered predatory if the insurance plan or program under which the insurance was issued is approved pursuant to Section 1010-b of Title 35 of the D.C. Code.

D. Penalties/Damages

1. *Punitive Damages*

Available punitive damages were capped at 500% of damages awarded for interest, fees and principal in the engrossed version of the D.C. Act. Due to Councilmember Jarvis' amendment, available punitive damages are now capped at 600% of damages awarded for interest, fees and principal.

2. *Attorneys Fees*

The amendment makes the award of reasonable attorneys' fees and costs mandatory when a borrower brings a successful action challenging a loan as predatory and there is an award of damages in excess of $100, an order for injunctive relief, or a reformation of the loan. This change was made to encourage victims of predatory lending to seek legal counsel, improve their opportunity to receive legal representation and discourage predatory lending in the District.

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Should you have any questions regarding Massachusetts' new high cost home loan regulations or DC's predatory lending bill, please call Gus Avrakotos at 202-778-9075 or Tara Goebel at 202-778-9261.

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MORTGAGE BANKING/CONSUMER FINANCE GROUP

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