

## Mortgage Banking Commentary

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NOVEMBER 15, 2000

### Recent Predatory Lending Developments

#### I. D.C.'S COUNCIL ON ECONOMIC DEVELOPMENT APPROVES PREDATORY LENDING BILL

##### Status

As reported in our September 7, 2000 Mortgage Banking Commentary, the D.C. Mortgage Foreclosure Task Force introduced the "Predatory Lending Protections and Mortgage Foreclosure Improvements Act of 2000," (herein the "Predatory Lending Measure") which, if passed, would implement a new foreclosure law and provide new protections for District residents who are the victims of predatory lending. On October 2, 2000, the D.C. Committee on Economic Development conducted a public hearing to discuss the proposed legislation, and on November 1, 2000 it approved the bill, now entitled the "Protections from Predatory Lending and Mortgage Foreclosure Improvements Act of 2000." **The bill will be voted upon by the entire D.C. Council on December 5, 2000 and, thus, potentially could become law by the end of the year.**

##### Action Required

The new bill contains several sections that were changed substantially since the bill was first introduced in July. Of note is a new definition of the term "home loan." As set forth below, the definition of "home loan" is written ambiguously, defining "home loan" in a limited manner, and then excluding (i) certain loans that are otherwise covered by the definition, and (ii) other loans that are not covered by the definition subject to certain conditions being satisfied. For all but (i) a fixed-rate, regularly amortizing, purchase money owner-occupied residential mortgage loan, (ii) an FHA-insured or VA-guaranteed loan or (iii) any residential mortgage loan in excess of the conforming loan limits of FNMA or FHLMC, the definition of "home loan" under the Predatory Lending Measure is virtually impossible to follow, leading to a litigation quagmire. Lenders who have a presence in the District and do not want to risk violating the law with virtually every non-purchase money loan in an amount under the conforming loan limits should contact the District's City Council as soon as possible to request that the term "home loan" be defined with precision.

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### **Definition of “Home Loan”**

Specifically, a “home loan” is now defined under the Predatory Lending Measure as a loan secured by a lien instrument encumbering residential real property wherein (i) the owner of the residential real property is one or more natural persons; (ii) the residential real property is improved with one or more structures, some part of which is a one- to four- family dwelling; (iii) the residential real property is occupied by the owner as the owner’s principal dwelling or in good faith is intended to be occupied by a borrower who is one or more natural persons as the borrower’s principal dwelling at the time of the loan closing; and (iv) the loan satisfies one of the following requirements:

- I. If the primary purpose of the loan is for any combination of purchasing or refinancing the borrower’s residential real property or improving an existing structure on the borrower’s residential real property;
  - (i) The principal amount of the note at the initial funding, secured by a residential lien instrument creating a first lien, shall not exceed the conforming loan principal amount dollar limit for a single-family dwelling loan as established from time to time by the Federal National Mortgage Association [FNMA] or Federal Home Loan Mortgage Corporation [FHLMC] [currently, \$252,700]; or
  - (ii) The sum of the principal amount of the note as the initial funding, secured by a residential lien instrument creating a subordinate lien other than a first lien, plus the sum of the unpaid principal balances of all other senior priority lien instruments encumbering the residential real property for any combination of purchasing or refinancing the borrower’s residential real property, shall not exceed the conforming loan principal amount dollar limit for a single-family dwelling loan as established from time to time by the Federal National Mortgage Association [FNMA] or Federal Home Loan Mortgage Corporation [FHLMC] [currently \$252,700].
- II. If (i) the loan is evidenced by an obligation other than a promissory note; (ii) the loan obligation is secured by liens on real property or personal property in addition to the residential real property and related personal property that is the owner’s principal dwelling; or (iii) the proceeds of the note are advanced for a primary purpose other than the purchase, finance or improvement of the residential real property and related personal property which is the owner’s principal dwelling, the assessed value at the time of initial funding cannot exceed one million dollars.

See Section 101(12)(A) of D.C. Bill No. 13-800 (emphasis added).

As you can see, the definition of “home loan” under the District’s Predatory Lending Measure is more confusing than initially proposed. As worded, a “home loan” does not include (i) any first-lien residential mortgage loan in an amount in excess of the FNMA or FHLMC conforming loan limits, or (ii) any subordinate-lien residential mortgage loan where the sum of the loan amount when added to the unpaid balance of prior senior liens has a principal dollar amount in excess of the FNMA or FHLMC conforming loan limits. Moreover, as the part of the definition of a “home loan” in section 101(12)(A)(iv)(I) is based on the primary purpose of the loan being for any combination of (i) purchasing, (ii) refinancing, or (iii) essentially home improvement, a loan secured by the borrower’s residence that is strictly for debt consolidation, such as a cash-out home equity loan, arguably is not a “home loan” for purposes of the District’s Act, regardless of the loan amount. Note that this view appears to be consistent with the definition of “home loan” for a first-lien loan in section 101(12)(A)(iv)(I)(i) or for a subordinate-lien loan in section 101(12)(A)(iv)(I)(ii), as the condition precedent to either a first-lien or subordinate-lien loan is the primary purpose of the loan being for any combination of (i) purchasing, (ii) refinancing, or (iii) essentially home improvement. This may not be the intent of the measure, but the plain language of the bill would appear to support such a reading.

We also note that part of the “home loan” definition found in section 101(12)(A)(iv)(II) identifies a “home loan” as a loan secured by a lien on real property or personal property in addition to the residential real property. This provision would appear to be in conflict with the District’s Mortgage Lending or Broker Act (the “Mortgage Act”), as this provision appears to permit mortgage loans secured by the residential real estate and personal property, when licensees under the Mortgage Act are prohibited from making such loans. See D.C. Code Ann. § 26-1014.

An understanding of the types of residential mortgage loans that are included in the definition of “home loan” is all the more confusing when the types of loans expressly excluded from the definition of “home loan” are taken into consideration. Some of the types of loans expressly excluded from the definition of “home loan,” such as a purchase money mortgage, are expressly included in the definition of “home loan.” Moreover, the Predatory Lending Measure excludes loans from the definition of “home loans” when such loans would not be covered by the “home loan” definition in the first place, such as certain home equity lines of credit, or reverse mortgages. Many of these loans excluded from the definition of “home loan” are excluded only if certain conditions are satisfied. Thus, the specter is raised that litigation could be brought against lenders who make loans that are not covered by the definition of “home loan” because the loans do not meet all the conditions to satisfy the exclusion from “home loans.”

This list of loans excluded from the definition of “home loans” and, thus, from all provisions of the Predatory Lending Measure that apply to “home loans” is as follows (our comments are in italics):

- (1) A “home equity conversion mortgage,” as defined under the National Housing Act. *Although a home equity conversion mortgage (i.e. a reverse mortgage) meeting this definition is excluded from the definition of “home loan,” a home equity conversion mortgage does not appear to fall within the definition of “home loan” in the first place.*
- (2) A construction loan for the initial construction of one or more single-family dwellings.
- (3) A loan secured by a “purchase money lien instrument” encumbering residential real property that is the owner’s principal dwelling. A “purchase money lien instrument” is

defined as a lien instrument given to a vendee of real property or to a noteowner other than the vendee to the extent that the primary purpose for the loan proceeds are used to: (i) acquire an ownership interest in real property; or (ii) construct improvements on real property if the lien instrument is given as part of the same transaction in which an ownership in the real property is acquired.

- (4) A loan secured by a residential lien instrument encumbering residential real property which is the owner's principal dwelling where the primary purpose of the loan is for the refinancing of the owner's principal dwelling, with or without improving the owner's principal dwelling, and where the "home loan adjusted rate" is equal to or less than the "home loan reference rate," excluding any loan where the first interest rate adjustment or principal and interest payment amount adjustment is permitted before the fifth anniversary of the date of the note secured by the residential lien instrument. *The terms "home loan adjusted rate" and "home loan reference rate" are defined terms in the Predatory Lending Measure. The "home loan adjusted rate" and "home loan reference rate" calculation is required to exclude certain refinance ARM loans from the definition of "home loan," but not purchase money ARM loans (as all purchase money loans apparently are excluded). Any refinance ARM loan, where the first interest rate or principal and interest payment adjustment is permitted before the fifth anniversary date of the note, is not excluded from the definition of "home loan," regardless of this calculation. Any refinance ARM loan, where (i) such "first adjustment" occurs after the fifth anniversary date and (ii) the "home loan adjusted rate" is not at least equal to the "home loan reference rate," also remains a "home loan" for purposes of the Predatory Lending Measure.*

The "home rate reference rate" is defined in the Act as the sum of: (a) the "Average Conventional 30-Year Commitment Rate" for fixed-rate mortgages originated in the Northeast region, as reported periodically by FHLMC in the Primary Mortgage Market Survey; and (b) the product of 25 basis points times the "Fees and Points" reported for 30-year fixed-rate mortgages originated in the Northeast region as reported by FHLMC.

The "home loan adjusted rate" is defined as either:

- (a) For adjustable interest rate mortgage loans, the home loan adjusted interest rate is determined by adding and subtracting the recognized 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 the fixed margin amount stated or referred to in the note, plus 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 1.25%; or
- (b) For any other mortgage loan, the home loan adjusted interest rate is 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 1%.

- (5) A first lien loan and second lien loan created simultaneously in the same transaction and secured by residential lien instruments encumbering the same residential real property which is the owner's principal dwelling where the primary purpose of the loan is for the refinancing of the owner's principal dwelling, with or without improving the owner's principal dwelling, and where the average "home loan adjusted rate" for both loans is equal to or less than the "home loan reference rate," excluding any loan where the first interest rate adjustment or principal and interest payment amount adjustment is permitted before the fifth anniversary of the date of the note secured by the residential lien instrument. A formula for determining the "average home loan adjusted rate" is set forth in this section.
- (6) Any loan made in conformity with the "highest rating categories" of FNMA and FHLMC, at the time the interest rate and origination/discount points and fees are agreed to by the borrower and lender making the loan, regardless of whether the loan is purchased by FNMA or FHLMC.
- (7) Any loan made, guaranteed or insured in whole or in part by agencies of the United States, the District, or any state or municipal government including FHA, GNMA, HUD, VA and the Housing Finance Agency of the District.
- (8) Any loan made in conformity with a documented loan program of FHLMC, FNMA or FHLBS, a similar, national, secondary-market making organization regulated or controlled by the United States, or an insured depository institution, whether or not the loan is purchased by one of these entities, which loan program has been reviewed and approved by the Mayor, under section 1409 (*which section is not defined further*).
- (9) A "home equity loan" where the principal amount can be re-advanced, that satisfies all of the following conditions: (a) the residential lien instrument must be a credit line deed of trust, as defined under the District's law, for a single family residential property and must comply with the notice requirements of the Deed of Trust Act; (b) there are no origination/discount points and fees charged to any borrower or owner of the residential real property, with certain fee exceptions; (c) the home equity loan is prepayable at any time without additional cost, fee or premium; and (d) interest on the home equity loan accrues and is charged only on the unpaid principal balance, calculated daily. *We note that although this type of home equity loan is excluded from the definition of "home loan," home equity revolving lines of credit do not necessarily fall within the definition of "home loan" in the first place.*
- (10) Bridge loans where (a) the note is secured by a single residential lien instrument or 2 residential lien instruments that encumber at all times 2 residential real properties, one of which is purchased by the borrower simultaneously with the funding of the loan and is located in the District of Columbia; (b) the stated term and maturity of the note evidencing the bridge loan is not more than one year; (c) no origination/discount points and fees were charged to any borrower or owner of the residential real properties; (d) the bridge loan is prepayable at any time without additional cost, fee or premium; and (e) interest on the bridge loan accrues and is charged only on the unpaid principal balance, calculated daily.

The District's Predatory Lending Measure also adds some vague reference to "an information form" that will serve as primary evidence of whether a loan satisfies the definition of "home loan" or is excluded from the definition of "home loan." Who must prepare or keep this form is not stated.

Additionally, the list of prohibited practices set forth in Section 601 of the Act now applies to those making, brokering, arranging, funding or servicing a "home loan," by any mortgage broker, mortgage lender or other person. In the Predatory Lending Measure's original draft, this list of prohibited practices only applied to those who made, brokered or arranged home loans in the District. Few of the prohibited practices apply to mere servicers. It also is unclear how these prohibited practices will apply to an entity merely providing the funds with which a loan will be closed, or if this provision could be read to reach an entity providing a warehouse line of credit. If a source provides the funding for a loan that meets the definition "home loan," which "home loan" violates one of the prohibited practices, then a question arises as to whether the funding source is subject to the penalties under the Predatory Lending Measure. A list of prohibited practices was included in our September 7, 2000 Mortgage Banking Commentary.

## II. CITY OF OAKLAND, CALIFORNIA ANNOUNCES PREDATORY LENDING ORDINANCE

Last month, the City of Oakland proposed an ordinance that would amend existing Ordinance No. 12066. As proposed, this ordinance affects (i) depositories that provide the City with banking services; and (ii) depositories and/or private financial institutions that seek (a) City business under the Linked Banking Service Program; (b) to participate as a lender in any development project financed by City loans; or (c) monetary grants or mortgage programs sponsored by the City. If the ordinance is passed as proposed, such institutions may be required to satisfy reporting requirements and provide mandatory certifications.

Among other requirements, any depository or other private financial institution (which terms are not defined) that seeks City business under the Linked Banking Service Program or seeks to participate as a lender in any development project financed by City loans, or seeks monetary grants or mortgage programs sponsored by the City must certify that "neither they, nor their affiliates (as the term "affiliate" is defined under the federal Bank Holding Company Act of 1956, as amended, or other appropriate law as determined by the City Manager), engage in or will engage in predatory lending practices."

A "predatory lending practice" is defined as a pattern or practice of making "predatory loans." A "predatory loan" is any loan, whether first- or subordinate-lien, open- or closed-end, that (1)(a) has an APR that exceeds the U.S. Treasury rate by more than 8 percentage points; or (b) has points and fees that exceed 6 percent of the total loan amount; and (2) includes any of the following features or practices:

- **Prepayment penalties** over 2% of the amount of the prepayment after 12 months from loan origination;
- **Balloon payments** due in 7 or fewer years;
- **Repeated refinancings** without benefit to the borrower;
- **Fraudulent or deceptive marketing** efforts in loan origination;

- **Qualifying a borrower based on the equity of their home rather than their ability to repay;**
- **Financing credit life or other insurance** into the loan without disclosure or permission of the borrower;
- **Terms that cause the mortgage balance to increase instead of decrease,** including **negative amortization;** or
- **Financing points and fees** in excess of 7% of the loan amount.

Finally, the ordinance provides that if and when the federal government adopts a definition of “predatory lending practice” or “predatory loan,” the definitions of “predatory lending practice” and “predatory loan” will automatically change to be consistent with such federal definition.

### **III. GEORGIA IS EXPECTED TO INTRODUCE PREDATORY LENDING BILL IN 2001**

It is expected that Senator Vincent Fort will introduce the “Georgia Fair Lending Act” in the Georgia State Senate. According to the draft Senator Fort distributed on September 12, 2000, the bill would primarily regulate lenders of high-cost home loans, although assignees, holders and servicers of a home loan that was made, arranged, or assigned by a person financing home improvements to the dwelling of a borrower are subject to all affirmative claims and defenses which the borrower may have against the seller, home improvement contractor, broker, or lender with respect to such mortgage or home improvements.

Of note is the bill’s definition of a “high cost home loan” which would subject open-end credit plans (other than reverse mortgage transactions) to regulation under the Act where such loans are (1) secured by real estate; (2) for a principal amount of less than the conforming loan size limit for a single-family dwelling as established by FNMA (currently \$252,700); and (3) where either the (i) APR equals or exceeds 4% over the weekly average yield on U.S. Treasury securities with a comparable duration to the term of the home loan (subject to certain conditions); or (ii) total points and fees (as such term is defined) exceed 3% of the total loan amount.

The bill sets forth a list of prohibited practices that include restrictions or prohibitions on prepayment fees; the financing of credit life, credit disability, credit unemployment or credit property insurance; flipping; recommending or encouraging default; late fees; call provisions; balloon payments; negative amortization; increased interest rates; advance payments; modification or deferral fees; mandatory arbitration clauses; lending without home ownership counseling; lending without due regard to repayment ability; financing of fees or charges; refinancing existing high-cost home loans; and home improvements contracts.

Violations of the Act are harsh for those that intentionally violate its provisions. An intentional violation renders the home loan agreement void, and the lender has no right to collect, receive or retain any principal, interest, or other charges whatsoever with respect to the loan, and the borrower can recover any payments made under the agreement. Any person who knowingly violates the Act is guilty of a misdemeanor and, on conviction, subject to a fine of \$1,000 or less and/or imprisonment of six months or less. Any person who violates the Act is liable to the borrower for actual, statutory, and punitive damages, costs and reasonable attorney’s fees, and injunctive, declaratory, or such other equitable relief as deemed appropriate.

## MORTGAGE BANKING/CONSUMER FINANCE GROUP

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