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FINANCIAL SERVICES REGULATORY & ENFORCEMENT UPDATE

Federal Reserve Board Issues Final Rule Addressing Mortgage Lending and Servicing Practices under Regulation Z

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On July 14, 2008, the Board of Governors of the Federal Reserve System (the "FRB") issued a final rule (the "Final Rule") amending Regulation Z and the FRB's Official Staff Commentary, both of which implement the Truth in Lending Act (TILA).[1] The revisions to Regulation Z become effective on October 1, 2009, except for the escrow provisions, which take effect April 11, 2010. The Final Rule was adopted in part as a response to recent problems in the home mortgage loan market, including the recent increase in subprime mortgage loan delinquencies and foreclosures. It applies to all mortgage lenders and servicers, not just banks, thrifts and other insured depository institutions.

The Final Rule establishes a new category of "higher-priced mortgage loans," which should include nearly all closed-end subprime mortgage loans that are secured by a consumer's principal dwelling, and prohibits lenders from making higher-priced mortgage loans without regard to a borrower's ability to repay. The Final Rule also prohibits certain servicing practices as well as the coercion of appraisers to misrepresent the value of a home. The restrictions pertaining to "yield-spread premiums" were omitted from the Final Rule to allow the FRB additional time to consider alternative approaches.

Some of these restriction on higher-priced mortgage loans are very similar to those imposed by the Home Ownership and Equity Protection Act (HOEPA). HOEPA was enacted in 1994 as an amendment to TILA and creates a special class of mortgage loans based on the loans' interest rates or fees. Loans above HOEPA's triggers (HOEPA-covered loans) require additional disclosures and are subject to substantive restrictions on loan terms. HOEPA-covered loans also carry strict assignee liability. Notably, however, the Final Rule does not generally impose liability on assignees for the acts of the lender or any previous holder of a higher-priced mortgage loan.

The Final Rule was adopted under Section 129(l)(2) of TILA, which authorizes the FRB to prohibit unfair or deceptive

practices (the "HOEPA Authority") in connection with mortgage loans, abusive practices and practices relating to refinancings that are not otherwise in the interest of the borrower; and under the FRB's general rulemaking authority under TILA, which authorizes the FRB to issue regulations implementing TILA to carry out its purposes, facilitate compliance, prevent evasion, exempt certain classes of transaction from coverage, and require disclosures in advertisements for closed-end and open-end credit plans.[2] For regulations promulgated under the HOEPA Authority, state attorneys general may bring enforcement actions to enforce these provisions and enhanced damages are available under Section 129(l)(2) of TILA. A state attorney general is generally required to provide prior notice and a copy of the complaint to the federal agency responsible for administrative enforcement and that agency may intervene in the action.

Comments on the Proposed Rule

The Final Rule is based on the FRB's proposed rule (the "Proposed Rule") published on January 8, 2008.[3] The FRB received approximately 4,700 public comments on the Proposed Rule from a variety of commenters, including financial institutions, secondary market participants, mortgage brokers, realtors, trade associations, individual consumers, community groups, federal and state regulators, elected officials, appraisers and academics.

Generally, commenters supported the FRB's efforts to protect consumers from unfair mortgage lending practices, but many commenters urged adoption of a narrower definition of the term "higher-priced mortgage loans." Several commenters expressed concerns about the increased costs and burdens associated with the new requirements, including the concern that, as has been the experience under HOEPA, creditors may largely abandon making higher-priced mortgage loans if the regulatory hurdles are too high. Financial services industry commenters also expressed concerns regarding possible risks of increased legal liability.

Other commenters urged the FRB to adopt the rules under its general TILA rulemaking authority instead of its HOEPA Authority, arguing that the HOEPA Authority imposes substantial and disproportionate penalties on lenders for violations. Additionally, some commenters suggested that the FRB expand its use of the HOEPA Authority and coordinate with the Department of Housing and Urban Development (HUD) to ensure that TILA disclosures are consistent with disclosures required under the Real Estate Settlement Procedures Act. The FRB has indicated its intention to coordinate with HUD.

Higher-Priced Mortgage Loans

Because many of the new restrictions are only imposed on higher-priced mortgage loans, the definition of this term is key and will determine the scope of mortgage loans covered by the rule. The Proposed Rule defined the term as a closed-end mortgage loan where the annual percentage yield (APR) exceeded the yield on comparable

Treasury securities by at least 300 basis points for first-lien loans, or 500 basis points for subordinate-lien loans. Many commenters believed that the definition was too broad and would cover a significant number of prime loans. To address this concern, the FRB changed the index used in the Final Rule.

The Final Rule defines higher-priced mortgage loan as a consumer credit transaction secured by the consumer's principal dwelling with an annual percentage rate that exceeds the "average prime offer rate" for a comparable transaction as of the date the interest rate is set by 1.5 or more percentage points for loans secured by a first lien on a dwelling, or by 3.5 or more percentage points for loans secured by a subordinate lien on a dwelling. The average prime offer rate will be based on the Primary Mortgage Market Survey® (PMMS) conducted by Freddie Mac. The PMMS contains weekly average rates and points offered by a representative sample of creditors to prime borrowers seeking first-lien conforming mortgage loans, with 20 percent down payments. It includes interest rates for fixed-rate mortgages (15-year and 30-year) and variable-rate mortgages (1-year ARM and 5/1 ARM). These rates are published on Freddie Mac's web site.

The term higher-priced mortgage loan includes home purchase and home improvement loans, refinancings, and non-traditional mortgage loans to the extent that their APRs meet the definitional threshold. Certain types of loans, such as home equity lines of credit (HELOCs), reverse mortgage loans, construction-only loans, and bridge loans generally are excluded from the definition of "higher-priced mortgage loans." Although HELOCs are excluded from the definition, the Final Rule prohibits structuring closed-end higher-priced mortgage loans as open-end loans for the purpose of evading the new protections for higher-priced mortgage loans.

The FRB has also published for comment proposed revisions to Regulation C, which implements the Home Mortgage Disclosure Act. These revisions would conform the Regulation C definition of higher-priced mortgage loans with the Final Rule's new definition of higher-priced mortgage loans. Comments on these proposed changes are due by August 29, 2008. The short comment period is intended to made the changes to Regulation C final by the end of the year.

Ability to Pay and Verification of Income and Assets

The Proposed Rule created several rebuttable presumptions of violations of TILA if a creditor engaged in a "pattern or practice" of extending higher-priced mortgage loans or HOEPA-covered loans based on a consumer's collateral without regard to the consumer's repayment ability. The Final Rule, however, removes the "pattern or practice" language. Therefore, the Final Rule prohibits any HOEPA-

covered loan or higher-priced mortgage loan from being extended based on the consumer's collateral without regard to the consumer's repayment ability. The removal of the pattern or practice requirement reduces the borrower's burden of proof when trying to demonstrate a violation of this provision, and thus increases a lender's potential liability.

Under the Final Rule, a creditor is presumed to be in compliance with this requirement if the creditor verifies the consumer's income by using third-party documents that provide reasonably reliable evidence of the consumer's income and assets, including W-2 forms, tax returns, payroll receipts and bank statements. Additionally, a creditor has an affirmative defense if it fails to verify income or assets and the consumer's stated income or assets are not materially greater than what the creditor could have verified at closing.

Prepayment Penalties

The Proposed Rule prohibited the imposition of prepayment penalties on higher-priced mortgage loans in addition to HOEPA-covered loans, unless one of the following criteria were met: (i) the penalty period would not exceed five years from the date of loan consummation; (ii) the loan involved a refinancing of a loan made by the same creditor or its affiliate; (iii) the borrower's debt-to-income (DTI) ratio at loan consummation would not exceed 50 percent; and (iv) the penalty would not be prohibited under other applicable law. The Proposed Rule required the penalty period to expire at least 60 days before the first reset date on an adjustable rate mortgage.

The Final Rule on prepayment penalties differs from the Proposed Rule. Under the Final Rule, prepayment penalties in connection with higher-priced mortgage loans or HOEPA-covered loans are prohibited if the amount of payments can change during the first four years after loan consummation. For other types of higher-priced mortgage loans and HOEPA-covered loans, the Final Rule restricts prepayment penalties to the first two years of the loan's term and the penalty must not apply in the case of a refinancing by the creditor or its affiliates. These changes in the Final Rule eliminated the need (as contained in the Proposed Rule) for an expiration of the penalty at least 60 days before the reset date. In addition, unlike the Proposed Rule, the Final Rule does not prohibit prepayment penalties for higher-priced mortgage loans where a consumer's DTI ratio exceeds 50 percent.

Escrows for Taxes and Insurance

The Proposed Rule prohibited creditors from making a higher-priced mortgage loan secured by a first lien without establishing an escrow account for taxes and homeowner's insurance. Consumers were permitted to cancel their escrow accounts after an initial 12-month period. An exception was provided for loans secured by cooperatives

and the escrowing of insurance premiums is not required for loans secured by condominiums where the association has an obligation to maintain insurance. The Final Rule is substantially similar to the Proposed Rule and applies to higher-priced mortgage loans secured by a first lien. The Final Rule for escrow accounts takes effect for higher-priced mortgage loans consummated on or after April 11, 2010. For higher-priced mortgage loans secured by a manufactured homes, the provision is effective for loans consummated on or after October 1, 2010.

Coercion of Appraisers

The Proposed Rule prohibited creditors and mortgage brokers, or their affiliates, from coercing, influencing or otherwise encouraging appraisers to misstate or misrepresent the value of a consumer's principal dwelling. Also, creditors were prohibited from extending credit when they knew or had reason to know, at or before loan consummation, that an appraiser had been encouraged to misstate or misrepresent the value of a consumer's principal dwelling. The Final Rule is substantially similar to the Proposed Rule and applies to all closed-end mortgage loans secured by a consumer's principal dwelling. The "reason to know" language was removed in the Final Rule, but the preamble makes clear that creditors may not extend credit in willful disregard of the facts. The Final Rule contains several examples of permissible and impermissible conduct.

Loan Servicing

The Proposed Rule prohibited servicers from: (i) failing to credit a consumer's periodic payment as of the date received; (ii) imposing a late fee or delinquency charge due only to a consumer's failure to include a previous late fee or delinquency charge in a current payment; (iii) failing to provide a current schedule of servicing fees and charges within a reasonable time of request; or (iv) failing to provide an accurate payoff statement within a reasonable time upon request. The Final Rule excludes the requirement regarding fee schedules (described in subsection (iii) above) and clarifies that servicers are not required to credit partial payments. The Final Rule applies to all closed-end mortgage loans secured by a consumer's principal dwelling.

The FRB Staff Commentary accompanying the Final Rule provides some additional guidance on these prohibitions. For example, it establishes a safe harbor of five business days to provide a pay-off statement and permits a servicer to establish reasonable requirements for payoff requests (i.e., in writing to a specific address or fax number). It also permits a servicer to establish reasonable requirements for making payments (i.e., cut-off time of 5:00 p.m. for receipt, specified location for payment). In the absence of any specific requirements, a consumer may make payments at any location where the servicer conducts business and at any time during normal business hours.

Advertising Practices and Disclosures

The Proposed Rule amended Regulation Z's advertising disclosure rules to prohibit: (i) advertising a "fixed" rate without disclosing that rate or payment was only fixed for a limited period of time; (ii) comparing an actual or hypothetical rate or payment obligation without noting that the rate or payment will apply over the term of loan; (iii) advertising that characterizes the product offered as a "government loan"; (iv) prominently advertising the name of the consumer's current lender without noting that the advertisement is from an unaffiliated lender; (v) advertising that a loan is a debt elimination product if it is just replacing one debt obligation with another; (vi) advertising that falsely creates the impression that a lender or broker has a fiduciary relationship with a consumer; and (vi) providing initial rate and payment information in a foreign language while providing other disclosures only in English. The Proposed Rule also modified the "clear and conspicuous" standards as well as the disclosure requirements for introductory terms for home equity plan advertisements, and also required creditors to state with equal prominence all applicable rates or payments in close proximity to "teaser" rates.

The Final Rule's provisions are substantially similar to those in the Proposed Rule and apply to all mortgage loans.

Timing of Disclosures

The Proposed Rule required creditors to provide early good faith estimate disclosures to consumers in both purchase money and non-purchase money closed-end mortgage loan transactions. Currently, creditors are not required to deliver mortgage loan disclosures on non-purchase money mortgage transactions until consummation. Under the Final Rule, creditors are required to provide the consumer with a payment schedule and an APR that reflects the fully indexed rate for hybrid and payment-option adjustable-rate mortgages no later than three business days after the consumer's loan application and before the consumer has paid a substantial fee. This requirement is designed to give consumers an opportunity to review the credit terms offered and comparison shop before deciding to move forward with the transaction.

The Final Rule applies to all closed-end mortgage loans secured by a consumer's principal dwelling.

Mortgage Broker Compensation (Yield Spread Premiums)

With respect to all closed-end mortgage loans, the Proposed Rule prohibited creditors from paying yield spread premiums to mortgage brokers unless the consumer and the broker entered into a written agreement disclosing the total compensation of the broker. These restrictions were designed to limit the

broker's incentive to offer a higher-rate mortgage loan before telling the consumer the rate that he or she could qualify for. After consumer testing, the FRB determined that the required disclosures might confuse, rather than inform, consumers. Therefore, this prohibition was not adopted in the Final Rule.

Endnotes

1 15 U.S.C. §§ 1601 et seq. (TILA); 12 C.F.R Part 226 (Regulation Z).

2 *See* 15 U.S.C. § 1639(l)(2). Although HOEPA does not establish a standard for what is unfair or deceptive, the legislative history for HOEPA indicates that the FRB should consider the standards employed for interpreting state unfair or deceptive trade practices acts and the Federal Trade Commission Act. H. Conf. Rep. 103-652, p 162 (1994).

3 73 Fed. Reg. 1671 (Jan. 8, 2008).

If you have any questions regarding the Final Rule or TILA, please feel free to contact the following attorneys or any of your regular contacts at the firm. To learn more about our Financial Services Regulatory and Enforcement Practice, please visit http://www.mayerbrown.com/financialservices-regulatoryandenforcement/overview/index.asp

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