



Banking, Finance & Financial Institutions Law Alert

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Fed Approves New Mortgage Loan Rules

The Board of Governors of the Federal Reserve recently approved a final rule for home mortgage loans aimed at protecting consumers and facilitating responsible lending. In a nutshell, the final rule prohibits unfair, abusive, or deceptive home mortgage lending practices in an effort to protect vulnerable subprime borrowers. It also establishes advertising standards and requires certain mortgage disclosures to be given to consumers earlier in the loan process. Importantly, this new rule will apply to all mortgage lenders, not just those operating in the subprime market.

Federal Reserve Chairman Ben Bernanke characterized the final rule as being “intended to protect consumers from unfair or deceptive acts and practices in mortgage lending, while keeping credit available to qualified borrowers and supporting sustainable home ownership. Besides offering broader protection for consumers, a uniform set of rules will level the playing field for lenders and increase competition in the mortgage market, to the ultimate benefit of borrowers.”

The new rule amends Regulation Z (Truth in Lending) and was adopted under the Home Ownership and Equity Protection Act (HOEPA). The final rule substantially conforms to the proposed rule, which was released in December 2007, and establishes regulations for the new category of “higher-priced mortgages,” sets new standards for all closed-end mortgages secured by a consumer’s principal dwelling, and adds additional restrictions on mortgage loan advertising. The full text of the rule can be found at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080714a1.pdf>. Highlights are outlined below.

To begin, the final rule broadly defines “higher-priced mortgage” with the intent of capturing virtually all loans in the subprime market and at the same time excluding loans in the prime market. The Fed will publish an “average prime offer rate” index based on a survey currently published by Fannie Mae, and a loan will qualify as “higher-priced” if it is (i) a first-lien mortgage with an annual percentage rate 1.5 points above the index, or (ii) a subordinate-lien mortgage with an annual percentage rate 3.5 points above the index. A similar definition has been proposed (but not finalized) for use with Regulation C, relating to home mortgage disclosure requirements.

The basics of the higher-priced mortgage restrictions are as follows: Lenders are prohibited from making a loan without verifying the borrowers’ ability to repay the loan from income and other assets (aside from the home itself). Targeted directly at the practice of offering adjustable rate mortgages (ARMs)

with low initial payments, compliance with this regulation requires lenders to assess repayment ability based on the highest scheduled payments in the first seven years of the loan. More importantly, lenders may incur liability on a case-by-case basis, as borrowers will not have to demonstrate that any violations are part of a larger pattern or practice. Prepayment penalties are prohibited when payments may change within the initial four years of the loan, and cannot otherwise last for more than two years. Finally, these rules require the lender to establish an escrow account for the payment of property taxes and homeowners' insurance for first-priority mortgage loans, which the lender may permit the borrower to cancel after the first year of the loan.

In addition, the final rule prohibits a variety of servicing practices concerning closed-end mortgages secured by a consumer's principal dwelling including, but not limited to, failing to credit a payment to a customer's account as of the date payment is received, failing to provide a payoff statement within a reasonable period of time, and "pyramiding" late fees. The rules also prohibit creditors or brokers from coercing or encouraging an appraiser to misrepresent the value of a home. Furthermore, creditors will be required to provide a good faith estimate of loan costs (including a payment schedule) within three days after a consumer applies for any mortgage loan secured by the borrower's principal dwelling, including home improvement or refinance loans.

Advertising for all mortgages, regardless of type, priority, or the nature of the collateral, must contain additional information about rates, monthly payments and other loan features, such as the effect of discounted rates, the existence of a balloon payment, deductibility of certain kinds of interest for tax purposes, and the extent of promotional or introductory rates. The rule also bans seven specific advertising practices thought to be deceptive or misleading. These prohibited practices are: (i) advertising a rate or payment as "fixed" when it can (and often does) change over the course of the loan; (ii) making comparisons between actual or hypothetical rates or payments and the payment or simple annual rate that will be available for less than the full term of the loan, unless the advertisement contains all the applicable rates that might apply over the term of the loan and a statement that clarifies that such examples do not include taxes or insurance; (iii) referring to a government endorsement of a particular loan or program, unless the advertisement is for an FHA, VA, or similar loan program that is, in fact, sponsored by a federal, state or local government entity; (iv) sending any advertisement using the name of the homeowner's current mortgage lender, unless the advertisement is actually from that current lender or contains a statement naming the sending party and its affiliation (or lack thereof) to the homeowner's current lender; (v) using language promising to eliminate a consumer's debt or a consumer's existing obligations to another creditor; (vi) the use of the terms "counselor" or "financial adviser" to refer to mortgage brokers, creditors, or their respective agents and employees; and (vii) mixing Truth-in-Lending trigger terms presented in English with disclosures in a foreign language, or vice versa (advertisements wholly in one language will not be affected).

Compliance with the foregoing rules becomes mandatory on October 1, 2009, except for the escrow account requirement, which has an effective date of April 1, 2010 for site-built homes and October 1, 2010 for manufactured homes.