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Regulating Wrongful Lending: Protecting Borrowers from Themselves

What is the proper role of government in protecting borrowers from making bad loan choices? For over 30 years, the federal government has relied on empowering borrowers to make smart choices by requiring mortgage brokers and mortgage lenders to provide full and complete information about loan product types and the terms and conditions of loans. In effect, public policy expected consumers to seek to protect themselves by reading and digesting the disclosures required to be provided under the Truth in Lending Act and the Real Estate Settlement Procedures Act. The role of the government was not to ensure that borrowers necessarily made the correct or best choice under their personal circumstances. Instead, Congress sought to ensure that borrowers received sufficient information to enable them to engage in comparison shopping and make their own choice about mortgage loans. My, how things have changed!

Maybe the intricacies of loan products have surpassed the capabilities of consumers to comparison shop. Maybe consumers became blinded to the disclosed risks by virtue of their overwhelming desire to buy a house or cash out the equity of their house for lifestyle choices. Maybe brokers and lenders helped create unhealthy demand through their aggressive sales tactics. Maybe the dramatic rise in actual and anticipated delinquencies requires dramatic action without regard to the underlying causes.

Whatever the reason, public policy has shifted dramatically from expecting consumers to rely on disclosures to make their own reasonable choices to requiring brokers and lenders to make healthy choices for their customers. The heart of the debate centers on a few fundamental questions. The first such question, which we will address in this alert, is whether a lender should be obligated to determine the borrower's ability to repay a loan and a loan's provision of a net tangible benefit to the borrower. Other alerts will address the duty of care that mortgage brokers and mortgage lenders may be required to provide to consumers and the remedies that should be available in respect of legal violations.

By "ability to repay," we refer to requirements in statutes, regulations, and guidance documents prohibiting mortgage lenders from making a residential mortgage loan without considering the consumer's ability to repay the loan from his or her income or assets other than his or her equity in the property securing the loan. Essentially, it is an underwriting stricture seeking to prevent sheer asset-based lending, and is familiar in laws addressing high cost home loans, such as the federal Home Ownership Equity Protection Act (HOEPA). However, legislators and regulators are seeking to impose ability-to-repay standards beyond the sphere of HOEPA loans, and into the subprime, Alt-A, and even the prime mortgage market.

The phrase "net tangible benefit" is a nickname for a requirement primarily directed toward frequent refinancing of loans in which the financing of fees and other amounts into the new loan results in equity stripping, without providing the borrower a net tangible benefit from the transaction to justify the loss of equity. Again, these provisions have been spotted in several state anti-predatory lending laws, although they have rarely failed to send compliance experts into a whirlwind, wondering how realistically to implement such a subjective standard. Net tangible benefit standards have continued to surface, most recently in federal bills on both sides of Congress, but also in several state laws.

In 2008, industry watchers will be talking about the various enacted and proposed ability to repay and net tangible benefit standards. This client alert addresses the similarities and subtle (and not so subtle) differences between several of the more prominent examples.

Ability to Repay

Most, if not all, of the enacted or proposed ability to repay standards impose on lenders (and sometimes brokers) a restriction on making or brokering residential mortgage loans without considering or making a determination regarding the consumer's ability to repay the loan based on the consumer's income and assets other than the property securing the loan. Most (but not all) of the standards apply to some defined set of higher cost or subprime loans.

The ability to repay standards typically provide a list of mandatory considerations of consumer resources and obligations (e.g., credit history, current income, current obligations, debt-to-income ratio (DTI), and employment status). Several of the standards provide flexibility for the lender to consider reasonably expected income and other financial resources that may be documented with reasonably reliable third-party evidence. The ability to repay standards also typically provide rules for use in considering adjustable rate mortgage loans (ARMs), including those with initial fixed-rate periods, and in considering other alternative mortgage features, such as balloon payments or negative amortization.

While some of the ability to repay standards contain general presumptions of underwriting requirements that demonstrate, subject to rebuttal, either compliance or failure to comply with the standard, none of the standards discussed in this client alert provide objective or bright-line tests with which a lender or broker may comply in order to ensure compliance with the standards. They also typically apply, and require the determination to be made, as of the date of consummation, and thus compliance with the standards should not depend upon circumstances that arise during the life of the loan (at least those that were not reasonably foreseeable at the time the loan was made).

While the various ability to repay standards require lenders (or brokers) to consider a consumer's resources and obligations in light of the loan's repayment terms, they differ markedly in their expectations for lender/broker compliance as a practical matter. As explained below, one standard may require a lender's good faith or reasonable efforts in order to establish compliance, or require a "pattern or practice" of disregarding a consumer's ability to repay in order to establish a violation, while another standard may arguably establish a violation based on a single loan, regardless of the lender's policies or intentions.

The Frank Bill (H.R. 3915)

Representative Barney Frank (D-Ma.), Chairman of the Financial Services Committee of the House of Representatives, sponsored (along with several of his colleagues) a bill (H.R. 3915) that would, if enacted, be known as the "Mortgage Reform and Anti-Predatory Lending Act of 2007." H.R. 3915 passed the House in November 2007 and was referred to the Senate Banking Committee. Among many other provisions (including a net tangible benefit provision, addressed below), H.R. 3915 imposes an ability to repay requirement targeted essentially at subprime or Alt-A residential mortgage loans, as defined in the bill.

The Standard: H.R. 3915 would, if enacted, prohibit a creditor from making a residential mortgage loan unless the creditor makes a reasonable and good faith determination, based on verified and documented information, that at the time the loan is consummated, the consumer has a reasonable ability to repay the loan according to its terms (or to make the combined payments on all loans on the same dwelling about which the creditor knows or has reason to know), and all applicable taxes, insurance, and assessments.

A notable aspect of this H.R. 3915 standard is its allowance for a creditor acting reasonably and in good faith. Thus, this standard would capture a lender that is intentionally disregarding or failing to obtain information about a consumer's resources and obligations, but arguably would not capture, for example, a lender's judgment error made in good faith. Further, the standard's focus on reasonableness and knowledge may provide a lender with some flexibility for protecting itself from a claim of a violation.

Presumptions: While H.R. 3915's ability to repay standard would technically apply to all residential mortgage loans, presumptions under the bill would narrow the standard's resulting applicability to higher cost or other non-prime loans. Those presumptions also address the extent of assignee liability for a lender's failure to comply with the standard.

Under the bill, a creditor, and any assignee or securitizer of a loan, may presume that the loan has met the ability to repay requirement if the loan is a "qualified mortgage" (essentially a prime mortgage²), or a "qualified safe harbor mortgage" (essentially a proxy for a subprime or Alt-A loan meeting the requirements of the federal Interagency Guidance on Non-Traditional Mortgages and Statement on Subprime Lending³). Thus, as a conceptual matter, traditional prime mortgage loans, while technically subject to the ability to repay requirement, will benefit from a presumption of compliance.

In an attempt (whether successful or not) to target the applicability of the ability to pay requirement (as well as the net tangible benefit requirement, addressed below), and to reduce the requirement's impact on the secondary mortgage market, H.R. 3915 provides that the presumption of compliance for generally traditional prime loans is rebuttable only against the creditor, and only if the loan is a qualified safe harbor mortgage. Thus, the presumption that a loan has met the ability to repay standard is conclusive as to everyone (including assignees) other than the creditor. We believe the provision also was intended to make the presumption of compliance rebuttable (against the creditor) only in connection with qualified safe harbor mortgages, and conclusive in connection with qualified mortgages (although the provision could be more carefully drafted to fulfill that goal⁴). While that would spare qualified prime mortgages from being challenged under the ability to repay standard, it would arguably leave loans like reduced documentation loans, payment option ARMs, and certain hybrid ARMs, among other types of loans, open for heightened scrutiny.

H.R. 3915 would also amend the ability to repay requirement for HOEPA loans (the triggers for which would be lower under the bill), adding a presumption of a violation if the creditor engages in a pattern or practice of making those loans without verifying or documenting the consumers' repayment ability. It also would add a presumption that a consumer is able to

make the scheduled payments on a HOEPA loans if the consumer's total verified DTI does not exceed 50.

Regulations: H.R. 3915 also is unique among many ability to repay requirements in the breadth of its delegation to the federal banking agencies⁵ to expand or contract its applicability. The bill would require those agencies (in consultation with the Federal Trade Commission) to jointly prescribe regulations to carry out the purposes of the ability to repay standard (among other provisions), expressly allowing the agencies to revise, add to, or subtract from the criteria defining a "qualified mortgage" or a "qualified safe harbor mortgage." The regulations must be issued in final form within 12 months, and must take effect within 18 months, of enactment. Thus, arguably, in spite of the standards segregating prime or approved subprime/Alt-A mortgage loans established by Congress (assuming they were enacted), the agencies could potentially define away the presumptions created, subjecting all prime loans to the ability to repay standard.

Effect on State Laws: In addition to the presumptive safe harbor benefiting assignees and securitizers under H.R. 3915, as described above, another unique aspect of H.R. 3915's ability to repay standard (as well as its net tangible benefit requirement) is its limited preemption of state law as that law would apply to secondary market participants. Specifically, the bill's liability provision would, if enacted, expressly supersede any state law or application of state law that provides additional remedies against any assignee, securitizer, or securitization vehicle.⁶ The remedies described in the new liability provision would constitute the sole remedies against an assignee, securitizer, or securitization vehicle for a violation of the ability to repay (or net tangible benefit) standard or any other state law addressing that specific subject matter. However, the bill expressly would not preempt the applicability of state laws against creditors, so they would not see the benefit of preemption. The bill also would not preempt the availability of state law remedies for fraud, misrepresentation, deception, false advertising, or civil rights laws against an assignee, securitizer, or securitization vehicle for its own conduct in connection with the making of a loan, or the sale or purchase of residential mortgage loans or securities.

Chairman Frank has stated that this limited preemption provision was intended to recognize that states have

been more active in enacting consumer protections, and that creditors should continue to comply with those protections. However, the provision provides at least limited protection for secondary market participants, the Chairman explained, in the hopes that mortgage credit will still be reasonably available. This limited preemption of state law is unique among the other proposed federal ability to repay standards addressed below.

The Dodd Bill (S. 2452)

While H.R. 3915 was passed and referred to the Senate in November 2007, the Chairman of the Senate Banking Committee, Sen. Christopher Dodd (D-Conn.) introduced S. 2452 on December 12, 2007 and provided it to his committee. S. 2452 would, if enacted, be known as the “Home Ownership Preservation and Protection Act of 2007.” There are many similarities between S. 2452 and H.R. 3915. While the substantive provisions of S. 2452 arguably are more straightforward than those of its contemporary House counterpart, they are in some ways more stringent.

The Standard: Before entering into or otherwise facilitating a “subprime”⁷ or “nontraditional”⁸ mortgage loan, each mortgage originator would be required to verify the reasonable ability of the consumer to pay the principal and interest on the loan and any real estate taxes and homeowner insurance fees and premiums.

This standard is more onerous than H.R. 3915 in several ways. First, while H.R. 3915 applied its ability to repay standard only to “creditors,” the definition of “mortgage originator” under S. 2452 also expressly includes the broker and any other person who (for compensation) accepts applications for home mortgage loans, solicits those loans on behalf of consumers, negotiates terms or conditions of those loans on behalf of consumers or lenders, or negotiates sales of existing loans to lenders. The standard would require “each” mortgage originator to verify the consumer’s ability to repay, so a creditor may not rely upon a determination made by a broker, or vice versa.

Second, H.R. 3915 requires creditors to consider “the combined payments of all loans on the same dwelling,” but only if the creditor knows or has reason to know that another residential mortgage loan secured by the same dwelling will be made to the same consumer (e.g., a simultaneous second or piggy-back loan). S.

2452, however, does not appear to allow a creditor to assert its lack of reasonable knowledge of another loan on the property, but rather requires the creditor to consider the consumer’s payments under “any subordinate mortgages, including those that will be made contemporaneously to the same borrower.” Clearly creditors should know about existing liens on a home when making a residential mortgage loan, but S. 2452 would provide no cover for a creditor for any mistakes that may happen in good faith in the flurry of the closing process.

The lack of recognition for the creditor’s good faith brings us to our third important difference between the Senate and House bills. S. 2452 would not, as written, contain the “reasonable and good faith determination” qualifier that appears in H.R. 3915. This means that a lender bears the risk of a legal violation resulting from an error in judgment made in good faith.

Unlike H.R. 3915, the standard in S. 2452 does not specify that the verification of the consumer’s ability to repay must be based on circumstances at the time of loan consummation, although perhaps that timing may be implied through the standard’s use of the term “before entering into or otherwise facilitating” an applicable loan. However, clarity on that point would improve the provision.

Presumption: S. 2452 would presume that a loan fails to meet the ability to repay standard if, at the time of consummation, the DTI exceeds 45. The ratio must be calculated using the consumer’s total monthly debts, including total monthly housing payments, taxes, property, and private mortgage insurance, any required condominium fees, and any subordinate mortgages, including one made contemporaneously to the same borrower. In order to rebut that presumption, the creditor must show that the consumer has the ability to repay based upon the consumer’s residual income after current expenses and proposed home loan payments. While the bill would use a bright-line test to establish a presumptive failure to comply, it does not provide creditors with the relief of a presumption of compliance. In fact, it provides that no presumption that a loan is repayable arises solely from the fact that the DTI does not exceed 45.

Required Documentation: In addition to an ability to repay standard for subprime and nontraditional loans, the Senate bill contains a related requirement

that a mortgage originator, in connection with all home mortgage loans, must base its determination of ability to repay on documentation of all sources of income, verified by tax returns, payroll receipts, bank records, or the best and most appropriate form of documentation available, subject to such requirements and exceptions as determined appropriate by the Federal Reserve Board (the Federal Reserve); and on the consumer's DTI and residual income after payment of current expenses and proposed home loan payments. A consumer's statement of income and financial resources, without that other documentation, is not sufficient. Neither H.R. 3915 nor any of the other ability to repay provisions addressed in this client alert contains a similar provision that would apply beyond subprime/nontraditional loans to all loans.⁹

Regulations: While the Federal Reserve would be required to issue final regulations within 6 months to "carry out the Act," S. 2452's delegation to that agency of the authority to implement the standard arguably does not include the express sweeping authority to redefine the standard's scope by "revising, adding to, or subtracting from" the criteria for determining applicable loans, as in the House bill.

Federal Reserve Proposed Rule

On January 8, 2008, the Federal Reserve published a proposed revision of its HOEPA regulations in Regulation Z, including a revision of the ability to repay standard. Regulation Z currently prohibits creditors from engaging in a pattern or practice of extending HOEPA "high cost" loans to consumers based on consumers' collateral without regard to their repayment ability. There is a presumption that a creditor has violated that standard if the creditor engages in a pattern or practice of making HOEPA loans without verifying and documenting consumers' repayment ability. The Commentary to Regulation Z provides that whether a creditor is engaging in a pattern or practice of violating the ability to repay standard depends on the totality of the circumstances in the particular case, and it can be established without the use of a statistical process. However, solely acting in accordance with a lender's written or unwritten policies could establish such a pattern or practice. Otherwise, the Commentary clarifies that a pattern or practice is not established by isolated, random, or accidental acts.

Under its new proposed rule, however, the Federal Reserve interprets its authority to regulate unfair or deceptive practices beyond just those mortgage loans with rates or fees that meet HOEPA's high-cost triggers. The Federal Reserve is considering whether it should extend its current ability to repay standard to newly designated "higher-priced" mortgage loans,¹⁰ as well as HOEPA loans. Also beyond HOEPA, the proposed definition of "higher-priced mortgage loans" would include home purchase loans. In addition to expanding the applicability of the ability to repay standard, the rule proposes certain changes to the standard itself (which changes would then apply both to HOEPA loans and higher-priced mortgage loans).

The Standard: The proposed rule, if adopted, would prohibit creditors from engaging in a pattern or practice of extending credit under higher-priced mortgage loans without regard to consumers' ability to repay from sources other than the collateral itself. The proposed rule would clarify that the determination of the consumer's ability to repay relates to the conditions existing at the time of consummation.

A clearly unique feature of the proposed rule, as compared to the other federal proposals discussed above, is the requirement of demonstrating a pattern or practice of a failure to comply in order to establish a violation. The Federal Reserve proposes to keep that "pattern or practice" element of the standard (and apply it to higher-priced mortgage loans as well as HOEPA loans) because "creating civil liability of an originator that fails to assess repayment ability on any individual loan could inadvertently cause an unwarranted reduction in the availability of mortgage credit to consumers." While the Federal Reserve is declining to provide a quantitative standard for determining the existence of a pattern or practice or to give any examples, it is proposing to keep the Regulation Z Commentary language described above regarding the establishment of a pattern or practice.

While other proposed ability to repay requirements discussed in this client alert address simultaneous seconds, the proposed rule would add language to the Commentary providing that "where two different creditors are extending loans simultaneously, one a first-lien loans and the other a subordinate-lien loan, each creditor is expected to verify the obligation the consumer is undertaking with the other" (emphasis added). The proposed rule does not mention limiting this requirement to circumstances in which the

creditor reasonably knows of the existence of the other transaction. Nonetheless, as mentioned above, the ability to repay requirement as a whole requires a showing of “pattern or practice” in order to establish a violation.

Interestingly, the Federal Reserve recognizes in its proposed rule that borrowers usually pay off mortgage loans long before the loans mature, typically in five to ten years. The agency notes that rates on 30-year loans more closely track rates on Treasury securities with a maturity of five to ten years, while rates on ARMs more closely track rates for one- to five-year securities (depending upon the length of the initial fixed-rate period). Thus, in the context of calculating a loan’s APR spread – which is relevant in determining whether a loan is a higher-priced mortgage loan,¹¹ and thus subject to the ability to repay requirement – the proposed rule attempts to track the appropriate Treasury security comparisons. In addition, the proposed rule provides that a creditor does not violate the ability to repay standard if it has a reasonable basis to believe that consumers will be able to make loan payments for at least seven years, considering all the required factors and any other relevant factors. The Federal Reserve requests comments on whether specifying a shorter period of time would be appropriate.

As with H.R. 3915, the proposed rule would require lenders to consider the greater of the fully indexed rate or the initial rate. (In S. 2452, the creditor must assume the interest rate of an ARM loan is the fully indexed rate, but also may use a “credible market rate determined according to Federal Reserve regulations that are based on reasonable market expectations.”) However, the proposed rule would impose a special consideration for “step-rate” loans (a loan in which specific interest rate changes are agreed to in advance).¹² For a step-rate loan, the creditor must consider the consumer’s ability to repay based upon the highest interest rate possible within the first seven years of the loan’s term.

Presumptions: The proposed rule would offer several new presumptions of a violation of the ability to repay requirement, both for higher-priced mortgages and HOEPA loans. A creditor is presumed to have committed a violation if the creditor has engaged in a pattern or practice of failing to:

- (i) Verify and document the consumers’ repayment ability (this presumption is carried over from current regulations for HOEPA loans, as discussed above);

- (ii) Consider the consumers’ ability to repay based on the loans’ interest rate determined in accordance with the regulations (as discussed above, for ARMs the greater of the margin plus index at consummation, or the initial rate; for step-rate loans, the highest rate possible within the first 7 years);
- (iii) Consider the consumers’ ability to make fully-amortizing loan payments that include expected property taxes, homeowners insurance, mortgage insurance, and homeowner’s association dues, as applicable;
- (iv) Consider the ratio of consumers’ total debt obligations to income; or
- (v) Consider consumers’ income after paying debt obligations.

Those enumerated presumptions in the regulations would not be exhaustive – other patterns or practices could also lead to a violation. A creditor may rebut a presumption of a violation with sufficient evidence that the creditor did not engage in a pattern or practice of disregarding repayment ability.

Like H.R. 3915, and unlike S. 2452, the proposed rule would not identify a specific DTI ratio (nor would it identify a specific amount or level of residual income) that constitutes compliance or a violation, or that would subject the loan to a presumption of compliance or violation. The Federal Reserve explains that underwriting determinations depend on the totality of many interrelating factors. However, the proposed rule specifically asks for comments as to whether it should adopt some bright-line tests.

Required Documentation: The proposed rule also directly takes aim at reduced documentation loans. The proposed rule would prohibit creditors from making an individual higher-priced mortgage loan without verifying the income and assets on which they rely in making those loans (using the consumer’s W-2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer’s income or assets). This provision was intended to be flexible, allowing the kinds of documents consumers can, or should be able to, produce with little difficulty. However, the creditor may not rely solely on a statement from the consumer.

Although the proposed rule would require a showing of a pattern or practice of failing to comply with the ability to repay requirement, as described above, this documentation requirement would apply to each loan a creditor makes. However, the requirement would include a “no harm, no foul” qualifier. Specifically, the proposed rule would provide that a creditor does not violate the documentation requirement if the creditor demonstrates that the income or assets upon which it relied were not materially greater than the amounts the creditor would have been able to verify, pursuant to the proposed rule, at consummation. In requiring a creditor to verify income, the rule proposes a safe harbor, of sorts. If the amounts of income or assets on which the creditor relies were not materially greater than the creditor could have verified when the extension of credit was consummated, then the creditor would not have altered its decision to extend credit or the credit terms, so the creditor is not considered to have violated the requirement.

Statement on Subprime Mortgage Lending

In June 2007, the federal banking agencies¹³ issued a Statement on Subprime Mortgage Lending (the Statement) that addressed underwriting standards, among other topics. The Statement reminded applicable institutions to comply with real estate lending principles set forth in preexisting regulations, as well as in the agencies’ previously-issued Nontraditional Mortgage Guidance. The Statement focuses on a “subprime” consumer’s ability to repay a loan and to withstand payment shock that may occur under the terms of certain loan products. The Statement provides that it applies to “all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.”

Unlike the proposed regulations addressed above, the Statement is not itself an official agency opinion or a set of duly-promulgated regulations, but rather is an attempt by the agencies to provide guidance to applicable institutions in this area. However, many states have adopted the Statement, through a variety of processes, and are seeking to apply it in an enforceable and mandatory manner to the mortgage lenders they regulate. Additionally, both Fannie Mae and Freddie Mac have announced that they will require applicable loan purchases to comply with the Statement.¹⁴

Rather than applying an ability to repay standard to a defined set of loans (or all loans), like the proposals addressed above, the Statement applies to a certain type of a loan made to a certain type of consumer. While not fully clear, the Statement appears to address loans that entail payment shock, such as those with a significant increase in monthly payment when the rate adjusts to a fully indexed rate, loans with a wide spread between the initial rate and the fully indexed rate, and those without payment caps or periodic rate caps, or with very high caps. The Statement also appears to target reduced documentation loans, loans with features that may lead to frequent refinancing, and loans with substantial prepayment fees that extend beyond an initial rate reset period.

The Statement then attempts to target those loans when made to a “subprime borrower.” The Statement does not provide an objective definition of a subprime borrower, but rather lists characteristics that may describe those borrowers drawn from the interagency 2001 Expanded Guidance for Subprime Lending Programs (Expanded Guidance).¹⁵ The characteristics are meant to be illustrative and not to define specific parameters for all subprime borrowers.

The Standard: The Statement’s ability to repay standard utters the now-familiar refrain that “an institution’s analysis of a borrower’s repayment capacity should include an evaluation of the borrower’s ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.” The fully indexed rate (index rate at origination plus margin to be added after introductory period) must be considered regardless of any interest rate caps under the terms of the loan. The Statement failed to recognize the reasonable distinctions made in the previously released interagency Nontraditional Mortgage Guidance, which provided that “in different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product,” and that for those loans “a credible market rate should be used to qualify the borrower and determine repayment capacity.”

Under the Statement, the loan term for considering a fully amortizing repayment schedule must be the loan’s full term. For balloon loans with a borrower option for an extended amortization period, the creditor must consider the full term the borrower may choose.

While the Statement advises applicable institutions to assess a consumer's DTI, particularly for products involving reduced documentation or simultaneous second-lien mortgages, the Statement does not limit or express clear standards for acceptable DTIs for those or any other products. However, the Statement requires institutions to develop clear policies for those "risk layering" circumstances, and to demonstrate mitigating factors to support the underwriting approval and the consumer's repayment ability when those circumstances are present. A higher interest rate is not an acceptable mitigating factor.

While the Statement does not prohibit reduced documentation loans, it explains that institutions should be able to document a consumer's income using a recent W-2 statement, pay stub, or tax returns. Also, the Statement provides that "when underwriting higher risk loans, stated income and reduced documentation should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity." It does not provide for any flexibility to make exceptions.

As ability to repay proposals begin to fly off the shelves at the federal (and state) level, and particularly at the Federal Reserve, it is difficult to determine the continuing impact of the nebulous Statement and its ability to repay admonishments. While one could predict that the Statement will be obscured by the somewhat more forceful congressional and regulatory standards, the Statement will live on under the requirements of the states that will apply it to their regulated entities (unless some framework of federal preemption survives under one of the federal proposals).

Massachusetts AG Regulations

We cannot overlook the abundant state activity in this arena. Several states (including Colorado, Illinois, Maine, Minnesota, Missouri, Nevada, North Carolina, Ohio, and West Virginia) have enacted ability to repay requirements for certain types of loans or creditors. In a recent addition to the slate, in late 2007 the Attorney General (AG) of Massachusetts issued new regulations addressing unfair or deceptive acts or practices in mortgage lending. Those regulations apply to loans for which applications were and are received on or after January 2, 2008. The AG's previous regulations addressing unfair practices in mortgage lending applied only to residential mortgage loans other than for the

purchase or initial construction of residential property, or open-end home equity lines of credit. The new regulations broaden the scope of applicability, so that now they apply to all closed-end residential mortgage loan transactions, including the purchase, construction, or refinancing of an existing loan (although they continue to exempt reverse mortgages and open-end home equity lines of credit). The regulations do not recognize a high-cost trigger, or attempt to target subprime loans. Further, in addition to those mortgage lenders and brokers covered by the existing regulations, the new regulations apply to mortgage lenders and those individuals who work on behalf of those lenders, as well as individuals who work for or on behalf of mortgage brokers that are licensed under Massachusetts law.

The Standard: Among other requirements, the regulations declare that it is an unfair or deceptive act or practice for a mortgage broker to arrange, or a mortgage lender to make, a mortgage loan unless the mortgage broker or lender, based on information known at the time the loan is made, reasonably believes at the time the loan is expected to be made that the consumer will be able to repay the loan.

Based on the text of the Massachusetts AG standard, arguably it is still fair for a lender to make a loan it reasonably believes is repayable. While the exact thrust of these standards is still untested, the Massachusetts AG's allowance for the lender's reasonable belief is similar to H.R. 3915, which would protect a creditor's reasonable and good faith determination. S. 2452 veers away from recognizing the creditor's reasonableness, flatly requiring a creditor to verify the consumer's ability to repay.

The regulations' reference to a fully indexed rate (index rate prevailing at the date of loan origination plus the margin to be added to it after the expiration of an introductory interest rate) is familiar. However, the AG's office issued guidance providing that if the duration of the fixed starter rate on a hybrid ARM loan is somewhat long (i.e., 5, 7, or 10 years), the lender has the flexibility to "take into account" the fully indexed rate, stopping short of dictating precisely how applicable lenders or brokers must underwrite ARM loans to account for upward adjustments. Under those circumstances, the guidance states that "it is expected" that lenders and brokers would reasonably consider: (i) the duration of the introductory, fixed rate period; (ii) the magnitude of the ARM adjustment

when it occurs; (iii) subsequent ARM adjustments, accounting for caps applicable to periodic adjustments as well as overall caps; (iv) the resulting impact on the consumer's expected monthly payment obligations; and (v) other underwriting criteria used by the lender to reasonably determine whether the consumer will be able to repay the loan both during the introductory period and after the ARM adjustments.

Required Documentation: The regulations also provide, in connection with all applicable mortgage loans (regardless of cost) that a mortgage broker or lender may not process or make a mortgage loan without documentation verifying the consumer's income unless the broker or lender, as applicable, first provides to the consumer written documentation that the consumer signs prior to closing that: (i) identifies the consumer's income and the source of the income; and (ii) provides detailed information, if true, that by applying for a mortgage loan on a no- or limited documentation basis, the consumer will pay a higher interest rate or increased charges, or have less favorable terms for the mortgage loan. This latter requirement must include information concerning the precise increase in interest rate, charges, or the nature of the less favorable terms. This provision does not otherwise dictate the resources a lender must obtain and review in order to verify the consumer's income, although it provides that it is unfair for a mortgage lender to underwrite or close a loan without first verifying the employment or income of the borrower when the amount of the income stated is not reasonable for the actual employment status or experience of the borrower known to the lender, or when the borrower's stated employment or stated income is not reasonable in light of the borrower's circumstances known to the lender. It is also unfair for a mortgage lender or broker to process or make a mortgage loan on a no- or limited documentation basis if the borrower's stated income contradicts information the lender or broker previously obtained, absent a documented change in circumstances or other documented explanation. While the AG's regulations are not an outright prohibition on low- or no-documentation products, the precise comparison in the disclosure will make this product more difficult for lenders to offer.

New Era in Underwriting

What is the proper role of a lender (or a broker) in providing mortgage credit to consumers, or the proper

role of policy makers in directing the underwriting process? With the proliferation of ability to repay requirements, clearly policy makers agree that lenders and brokers should not provide access to mortgage credit based on the consumer's equity in his or her home, or on unsubstantiated statements regarding the consumer's income or assets. They also appear to recognize in most instances, however, that while they feel the need to regulate the underwriting process, that process entails a multifaceted and dynamic consideration and weighing of multiple factors. Setting objective requirements (such as DTI thresholds) may provide clarity and efficiency, but it may also present an artificial obstacle to providing deserved mortgage credit. Although the policy makers agree on some aspects of ability to repay underwriting, they are coming to very different conclusions about:

- The standard of conduct – recognizing a lender's reasonableness or good faith vs. requiring a demonstration of a pattern or practice vs. a strict one-loan liability for violations (which is onerous considering the subjective requirements of many of the proposals);
- The role of lenders' innovation in underwriting;
- The types of loans or consumer characteristics to which the requirement applies (higher cost or subprime loans vs. all loans regardless of cost or consumer characteristics);
- The treatment of simultaneous seconds;
- The presumptions of either compliance or violations, as a method of screening out prime loans;
- The imposition of assignee liability;
- The preemptive effect of a federal standard;
- The recognition that ARM loans with longer introductory periods perform and are priced more like fixed rate loans, and the ability to repay should be determined based on those more realistic terms;
- The applicability of the standard to mortgage brokers as well as lenders; and
- The delegation of authority to regulatory agencies to refine or define the underwriting standards and their applicability.

Net Tangible Benefit

Another addition to the mortgage lending vocabulary for 2008 is a net tangible benefit standard. As mentioned above, a so-called “net tangible benefit” standard is a protection against flipping and equity stripping, directed toward frequent refinancings by unscrupulous lenders in which the borrower does not receive a net tangible benefit from the transaction. Net tangible benefit or anti-flipping standards are found in several state anti-predatory lending laws, although once again the policy makers clearly recognize that it is difficult to enumerate objectively all the acceptable ways in which a borrower may benefit from a mortgage refinancing, even if a policy maker were inclined to do so. They are thus left with squishy subjective lists of considerations that are very difficult to implement.

Typically, as mentioned above, the net tangible benefits standards contain a list of good reasons for a borrower to refinance (e.g., obtaining a lower rate, converting from an ARM to a fixed-rate loan, receiving cash for a household emergency, etc.). Additionally, under certain state anti-predatory lending laws, the net tangible benefit provision would set up a time period since the date of a loan’s consummation, after which a refinancing of that loan is deemed free from the net tangible benefit analysis. As with many of the ability to repay standards, including those described above, the net tangible benefit standard sought to screen out prime loans, and remain applicable only to higher cost loans. However, the newly proposed standards appear to be branching out in applicability to broad swaths of loans, without providing additional clear guidance on how lenders (or brokers) can demonstrate with certainty that the loan is “beneficial.”

The Frank Bill (H.R. 3915)

The Standard: H.R. 3915 would, if enacted, provide that no creditor may extend credit in connection with any residential mortgage loan that involves a refinancing of a prior existing residential mortgage loan unless the creditor reasonably and in good faith determines, at the time the loan is consummated and on the basis of information known by or obtained in good faith by the creditor, that the refinanced loan will provide a net tangible benefit to the consumer. As with the ability to repay standard under the bill, H.R. 3915 provides for the good faith efforts of the creditor to offer beneficial refinancings, and recognizes that the creditor should not be held liable for information it did not

know and could not reasonably have known. However, the standard applies without regard to the timing for the refinancing (i.e., how long it has been since the borrower consummated the prior transaction).

H.R. 3915 also adds a provision imposing a net tangible benefit requirement in connection with HOEPA loans, the triggers for which would be lowered under the bill.

Presumption: The presumptions in favor of qualified mortgages and qualified safe harbor mortgages, described above as applicable to H.R. 3915’s ability to repay standard, would apply to the net tangible benefit standard, as well. One may presume that a refinancing loan meets the net tangible benefit requirement if the loan is a qualified mortgage or a qualified safe harbor mortgage, and that presumption is rebuttable only against the creditor, and only in connection with qualified safe harbor mortgages. Thus, the net tangible benefit requirement would apply essentially to higher cost or other non-prime loans.

If the presumptions are inapplicable, H.R. 3915 does not provide any clarity on what facts or circumstances would be deemed to provide a net tangible benefit. Instead, H.R. 3915 would presume that certain loans do not provide such a benefit. A residential mortgage loan that refinances a prior existing residential mortgage loan is not considered to provide a net tangible benefit to the consumer if the costs of the refinanced loan, including points, fees, and other charges, exceed the amount of any newly advanced principal without any corresponding changes in the terms of the refinanced loan that are advantageous to the consumer. This presumption appears to apply strictly, without allowances for the creditor’s good faith. However, while it is not fully clear, it appears to apply only in connection with the presumptions of compliance for qualified mortgages and qualified safe harbor mortgages, as described below (and above in connection with H.R. 3915’s ability to repay standard). Unfortunately, though, the declaration regarding loans that fail to provide a net tangible benefit falls prey to the overarching difficulty of complying with net tangible benefit standards, in that it does not provide any guidance as to which “advantageous” new terms would suffice.

Regulations: Again, H.R. 3915 would expressly allow the federal banking agencies to revise, add to, or subtract from the criteria defining a “qualified

mortgage” or a “qualified safe harbor mortgage,” and thereby determine the scope of applicability of the net tangible benefit standard.

Effect on State Laws: H.R. 3915 provides for limited preemption of state law as that law would apply to secondary market participants. As mentioned above, the bill’s liability provision would, if enacted, expressly supersede any state law or application of state law that provides additional remedies against any assignee, securitizer, or securitization vehicle.¹⁶ The remedies described in the new liability provision would constitute the sole remedies against an assignee, securitizer, or securitization vehicle for a violation of the net tangible benefit standard or any other state law addressing that specific subject matter. However, the bill would not preempt state laws applied against a creditor, nor would it preempt state law remedies for fraud, misrepresentation, deception, false advertising, or civil rights violations against an assignee, securitizer, or securitization vehicle for its own conduct.

The Dodd Bill (S. 2452)

The Standard: S. 2452 would, if enacted, prohibit an originator from making, providing, or arranging a subprime or nontraditional mortgage loan that involves a refinancing of a prior existing home mortgage loan, unless the new loan will provide a net tangible benefit to the consumer. Obviously, that standard represents a departure from H.R. 3915, in its applicability to an originator (rather than a “creditor”) that is making, providing, or arranging the new loan.¹⁷ Also, S. 2452 does not expressly allow for an originator acting reasonably or in good faith.

S. 2452 also adds a provision imposing a net tangible benefit requirement in connection with HOEPA loans, the triggers for which would be lowered under the bill.

Presumption: As in H.R. 3915, S. 2452 presumes that certain types of loans do not provide a net tangible benefit to the borrower. A mortgage loan that involves refinancing of a prior existing mortgage loan is not considered to provide a net tangible benefit to the borrower if the costs of the refinanced loan, including points, fees and other charges, exceed the amount of any newly advanced principal, less the points, fees, and other charges, without any corresponding changes in the terms of the refinanced loan that are advantageous to the borrower. As above, there is no guidance in

the bill as to what terms are “advantageous,” so as to justify the costs of refinancing.

Regulations: While the Federal Reserve would be required to issue final regulations within 6 months to “carry out the Act,” the Senate bill’s delegation to that agency of the authority to implement the standard arguably does not include the express sweeping authority to redefine the standard’s scope by “revising, adding to, or subtracting from” the criteria for determining applicable loans, as in the House bill.

Other Federal Standards

Other federal proposals described in this client alert – the Federal Reserve’s Proposed Rule, the Statement on Subprime Mortgage Lending, and the Nontraditional Mortgage Guidance – do not directly impose a net tangible benefit standard or expressly prohibit flipping. However, the Statement and the Guidance discuss the difficulty and expense borrowers have faced in seeking to refinance out of unaffordable loans (due to excessive fees, or negative amortization without sufficient property value appreciation). The Statement also seeks to apply its guidance to loans apt to cause payment shock, with “product features likely to result in frequent refinancing to maintain an affordable monthly payment.” While the Statement pegs flipping as a predatory practice, and warns that those conducting that practice face an “elevated risk” of violating the unfair or deceptive standards under the Federal Trade Commission Act (FTC Act), the Statement and Guidance focus more on refinancing borrowers out of bad loans, and not as directly on protecting borrowers from flipping.

Under the Federal Reserve’s Proposed Rule, the agency notes its statutory authority to “prohibit abusive practices or practices not in the interest of the borrower in connection with refinancings.” It also discusses borrowers’ difficulties in refinancing out of unaffordable loans. However, it primarily addresses these obstacles by prohibiting misleading advertising practices and imposing further limits on prepayment fees, and it does not propose a net tangible benefit standard. The Federal Reserve’s decision to rely on disclosures in this context, rather than jumping in with both feet to propose a vast regulatory framework, is particularly ironic, when Congress (in H.R. 3915 and S. 2452, to differing degrees) is poised to require the banking agencies to do just that.

Massachusetts Division of Banks Regulations

Under Massachusetts law, a lender is prohibited from refinancing a home loan unless the refinancing is in the borrower's interest. Although the statute refers to the "borrower's interest," rather than the arguably trendier phrase "net tangible benefit," it stands as a strong example of an existing standard at the state level.

The Standard: Massachusetts law prohibits a lender from knowingly refinancing a home loan that was consummated within the prior 60 months unless the refinancing is in the borrower's interest. Thus, the standard applies only to knowing violations, and only to refinancings within 60 months.

The Massachusetts Division of Banks (the Division) issued regulations providing factors, classifications, differentiations, and other adjustments and exceptions for classes of transactions to carry out that statutory standard. While the statute refers broadly to all refinancings (all "home loans"),¹⁸ the regulations essentially narrowed the applicability of the "borrower's interest" standard to certain conventional, higher cost mortgage loans. The Division's regulations provide that a home loan complies with the borrower's interest standard if it meets any of the following conditions:

- (a) The new home loan is guaranteed, originated, or funded by the Federal Housing Administration, the Department of Veterans Affairs, or other State or federal housing finance agencies;
- (b) The APR of the new loan at consummation does not exceed by more than 2.5 percentage points (for closed-end first-lien loans), or by more than 3.5 percentage points (for closed-end subordinate-lien loans), the yield on Treasury securities having comparable periods of maturity;
- (c) The new loan is an open-end loan and the APR under the agreement will not exceed at any time the Prime rate index as published in the Wall Street Journal plus a margin of one percentage point; or
- (d) The borrower is able to recoup the costs of refinancing the home loan within 2 years, taking into account the costs and fees, and the interest rate on the new home loan is reduced without increasing the amortization period of the new home loan compared to the original amortization term of the old home loan.

The Division's regulations also provide a glimpse into how a regulator attempts to implement a net tangible benefit standard. The regulations require a lender to "develop policies and procedures to demonstrate compliance" with the standard, to include at a minimum a worksheet or other document indicating how the lender determined that the new loan is in the borrower's interest. Under the regulations, the lender may request the borrower to acknowledge receipt of the worksheet or other documentation, but the lender is prohibited from requiring a borrower to sign a waiver of future claims.

The regulations provide that a lender may require the borrower to enter into a contract, agreeing that he or she will notify the lender within 30 days prior to filing any action alleging that the lender violated the borrower's interest standard. The borrower's notice must identify the borrower, reasonably describe the violation and the injury suffered, and include a written demand for relief. In addition to the "knowing" requirement in the standard itself, this provision is an attempt to allow lenders to cure an alleged violation prior to being subjected to an enforcement action.

While S. 2452 expressly applies its net tangible benefit standard to brokers and other "originators," the Division's regulations expressly prohibit a mortgage broker from making an affirmative determination that a home loan is in the borrower's interest, although the regulations do not prohibit the broker from requesting information from or transmitting information to a borrower on the lender's behalf.

Presumptions: Other than excluding the types of "OK loans" described in (a) through (d), above, the regulations do not offer any safe harbors or presumptions of compliance or violation. However, they provide expressly that a refinancing that does not come within the enumerated characteristics of an OK loan is not presumed to be a violation of the borrower's interest standard.

Who Gets to Decide?

Once again, what is the proper role of the lender (or broker) in deciding whether or not a loan is in the borrower's interest or whether the borrower will receive a benefit from the new loan that is tangible when considering the costs of refinancing? One might think a borrower with full information about a loan's terms and costs is the best person to decide whether

he or she will benefit from a new mortgage loan, and that these types of subjective and multifaceted requirements are unworkable in a financial regulatory context. Nonetheless, as these net tangible benefit standards become more prevalent in the non-HOEPA mortgage loan industry, it is worth noting some of the important distinctions related to:

- The standard of conduct – recognizing a lender’s good faith, requiring a demonstration of knowing violation, or imposing a strict liability for violations;
- The types of loans to which the requirement applies, as well as any presumptions of either compliance or violations;
- The presence of a time period after which a refinancing is free from scrutiny;
- The imposition of assignee liability;
- The preemptive effect of a federal standard;
- The applicability of the standard to mortgage brokers as well as lenders; and
- The mandate presented to regulatory agencies to define and implement the standards.

Additionally, as regulatory agencies undertake to implement these net tangible benefit standards, they will make important decisions about the type of documentation required to show the lender’s considerations and determinations, and whether the documentation will require or allow the borrower’s signature or acknowledgment. The agencies also will need to consider whether to provide lenders an opportunity to cure a violation or alleged violation.

It is rare that the obscure catchphrases of mortgage regulatory compliance – like ability to repay and net tangible benefit – become part of the national conversation. However, the upcoming and existing ability to repay and net tangible benefit standards have subtle (and not so subtle) distinctions that are worthy of recognition and discussion to understand their potential impact on the availability of mortgage credit in the near future and the changes to the mortgage terms and delivery systems that will be required to comply.

ENDNOTES

1 Under H.R. 3915, a “residential mortgage loan” would be defined as any loan primarily for personal, family, or household use that is secured by a mortgage, deed of trust, or other equivalent consensual security interest on a “dwelling” or residential real estate upon which is constructed or intended to be constructed a dwelling. A “dwelling” is a residential structure or mobile home that contains one to four family housing units, or individual units of condominiums or cooperatives. While H.R. 3915’s ability to repay standard technically applies to all “residential mortgage loans,” it establishes presumptions that result in the standard essentially applying only to subprime mortgage loans.

2 Under H.R. 3915, a “qualified mortgage” that benefits from a presumption of compliance with the ability to repay (and net tangible benefit) standard would be: (i) any first-lien residential mortgage loan with an annual percentage rate (APR) that does not equal or exceed the yield on securities issued by the Treasury Department that bear comparable periods of maturity by more than 3 percentage points; or has an APR that does not equal or exceed the most recent conventional mortgage rate, or such other APR as the federal banking agencies may establish, by more than 175 basis points; or (ii) any subordinate-lien residential mortgage loan with an APR that does not equal or exceed the yield on securities issued by the Treasury Department that bear comparable periods of maturity by more than 5 percentage points, or has an APR that does not equal or exceed the most recent conventional mortgage rate, or such other annual percentage rate as the federal banking agencies may establish, by more than 375 basis points; (iii) a loan made or guaranteed by the Secretary of Veterans Affairs (i.e., VA-guaranteed loans); and (iv) a mortgage insured under title II of the National Housing Act (12 U.S.C. §§ 1707 et seq.) (i.e., FHA loans). The “most recent conventional mortgage rate” is the contract interest rate on commitments for fixed-rate first mortgages most recently published in the Federal Reserve Statistical Release on selected interest rates (daily or weekly), and commonly referred to as the H.15 release (or any successor publication), in the week preceding a date of determination for purposes of applying this subsection.

3 H.R. 3915 would define a “qualified safe harbor mortgage” as any residential mortgage loan: (i) for which the income and financial resources of the consumer are verified and documented; (ii) for which the residential mortgage loan underwriting process is based on the fully-indexed rate, and takes into account all applicable taxes, insurance, and assessments; (iii) that does not provide for a repayment schedule that results in negative amortization at any time; (iv) meets such other requirements as may be established by regulation; and (v) for which any of the following factors apply with respect to such loan: (I) the periodic payment amount for principal and interest is fixed for a minimum of 5 years under the terms of the loan; (II) in the case of a variable rate loan, the APR varies based on a margin that is less than 3 percent over a single generally accepted interest rate index that is the basis for determining the rate of interest for the mortgage; or (III) the loan does not cause

the consumer's total monthly debts, including amounts under the loan, to exceed a percentage established by regulation of his or her monthly gross income or such other maximum percentage of such income as may be prescribed by regulation.

4 The presumption provision in H.R. 3915 states that a creditor, assignee, or securitizer of a loan may presume that the loan has met the ability to repay requirement (and the net tangible benefit requirement) if the loan is a "qualified mortgage" or a "qualified safe harbor mortgage." Thus, a loan that meets either definition (or both) is presumed to comply.

The provision of the bill that allows the conditions for rebutting that presumption of compliance with the ability to repay requirement (and the net tangible benefit requirement) appears to provide that the presumption of compliance is conclusive except under a set of circumstances that has two factors: (i) the person seeking to rebut the presumption is doing so against the creditor; and (ii) the loan that is the subject of the rebuttal is a qualified safe harbor mortgage.

One could argue, however, that the presumption and rebuttal provisions lead to an absurd result. Take the example of a traditional, prime, fixed-rate loan that satisfies the definition of both a "qualified mortgage" and a "qualified safe harbor mortgage." That loan benefits from a presumption of compliance, and according with the plain text of the bill, that presumption is rebuttable (since the loan is a qualified safe harbor mortgage). However, if the loan meets the definition of a qualified mortgage (assume the APR is below the ceilings), but does not meet the definition of a qualified safe harbor mortgage (assume it was a no-documentation loan, and there was no verification and documentation of income and resources). That loan also gets the benefit of the presumption (as it is a qualified mortgage), but that presumption is not rebuttable, according to the bill. The presumption is rebuttable only for qualified safe harbor mortgages, which definition excludes that loan. We do not believe that result was intended – that the presumption of compliance for a loan that fits both definitions is subject to challenge, but a loan that fits only one definition is not challengeable – and we can hold out hope for clarification as the Senate considers the bill.

5 Under H.R. 3915, the "federal banking agencies" would be the Board of Governors of the Federal Reserve (Federal Reserve), the Comptroller of the Currency (OCC), the Director of the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA).

6 H.R. 3915 would not expressly define the term "assignee." However, it would define "securitizer" as the person that transfers, conveys, or assigns, or causes the transfer, conveyance, or assignment of, residential mortgage loans, including through a special purpose vehicle, to any securitization vehicle, excluding any trustee that holds such loans solely for the benefit of the securitization vehicle. A "securitization vehicle" would mean a trust, corporation, partnership, limited liability entity, or special purpose entity that: (A) is the issuer, or is created by the issuer, of mortgage pass-through certificates, participation certificates,

mortgage-backed securities, or other similar securities backed by a pool of assets that includes residential mortgage loans; and (B) holds those loans.

7 S. 2452's definition of "subprime mortgage loan" is very similar to a loan that is not a qualified mortgage under H.R. 3915. Under S. 2452, a "subprime mortgage loan" is a home mortgage loan in which the APR exceeds the greater of two thresholds. The first threshold is based upon the APR's spread over similar Treasury securities. A home mortgage loan is a subprime mortgage loan if the difference between the APR for the loan and the yield on Treasury securities having comparable periods of maturity is equal to or greater than: (i) 3 percentage points for first lien mortgages or deeds of trust; or (ii) 5 percentage points for subordinate lien mortgages or deeds of trust. The second threshold is based upon the APR's spread over the "conventional mortgage rate." A home mortgage loan is a subprime mortgage loan if the difference between the APR and the annual yield on conventional mortgages, as published by the Federal Reserve in statistical release H.15 (or any successor publication thereto), is either equal to or greater than: (i) 1.75 percentage points for first lien mortgages or deeds of trust; or (ii) 3.75 percentage points for subordinate lien mortgages or deeds of trust.

8 Under S. 2452, a "nontraditional mortgage loan" is somewhat similar to a loan that is not a qualified safe harbor mortgage under the Frank Bill. A "nontraditional mortgage loan" means a home mortgage loan that allows a consumer to defer payment of principal or interest. Obviously, a loan must meet several other objective and subjective criteria in order to be considered a qualified safe harbor mortgage under H.R. 3915.

9 H.R. 3915 would indirectly impose a documentation requirement by generally providing that if a loan is higher cost, a lender must verify and document a consumer's income and financial resources in order for the loan to be a qualified safe harbor loan and come within the presumption of compliance. It also would amend the ability to repay requirement for HOEPA loans, adding a presumption of a violation if the creditor engages in a pattern or practice of making those loans without verifying or documenting the consumers' repayment ability.

10 The HOEPA proposed rule would define "higher-priced mortgage loans" similarly to "subprime mortgages" under S. 2452 and loans that are not "qualified" under H.R. 3915. A "higher-priced mortgage loan" would be defined as a consumer credit transaction secured by the consumer's principal dwelling for which the APR exceeds the yield on comparable Treasury securities by at least 3 percentage points for first-lien loans, or 5 percentage points for subordinate lien loans.

11 For purposes of determining whether a loan is a higher-priced mortgage, the proposed rule would establish a set of comparable Treasury securities that attempts to reflect the usual life of a loan. However, the proposed rule would not revise the Regulation Z Commentary language in connection with comparable Treasury securities for HOEPA loans.

For determining whether a loan is a higher-priced mortgage, the proposed rule would provide that comparable Treasury securities are determined as follows for variable rate loans: (i) for a loan with an initial rate that is fixed for more than 1 year, securities with a maturity matching the duration of the fixed-rate period, unless the fixed-rate period exceeds 7 years, in which case the creditor should use the rules applied to nonvariable rate loans; and (ii) for all other loans, securities with a maturity of 1 year. Comparable Treasury securities are determined as follows for non-variable rate loans: (i) for a loan with a term of 20 years or more, securities with a maturity of 10 years; (ii) for a loan with a term of more than 7 years but less than 20 years, securities with a maturity of 7 years; and (iii) for a loan with a term of 7 years or less, securities with a maturity matching the term of the transaction.

For determining whether a loan is a HOEPA loan, the Commentary to Regulation Z would continue to provide simply that “creditors must use the yield corresponding to the constant maturity that is closest to the loan’s maturity.”

12 Under the proposed rule, an example of a “step-rate” loan is one in which the parties agree that the interest rate on the loan would be 5 percent for 2 years, 6 percent for 2 years, and 7 percent thereafter.

13 The agencies issuing the Subprime Statement are the OCC, Federal Reserve, FDIC, OTS, and NCUA.

14 Freddie Mac stated specifically that in recognition of the Statement, on and after September 13, 2007, 6-month ARMs, 3/6-month ARMs, 1-year ARMs, 3/1 ARMs and 3-year ARMs that have a Margin of 400 basis points or more will be ineligible for sale to Freddie Mac under flow Purchase Contracts. Fannie Mae stated more broadly that all applicable mortgage loans with application dates on or after September 13, 2007, must be in compliance with all aspects of the Statement.

15 According to that 2001 Expanded Guidance on Subprime Lending Programs, generally subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- Bankruptcy in the last 5 years;
- Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or

- Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

16 H.R. 3915 would not expressly define the term “assignee.” However, it would define “securitizer” as the person that transfers, conveys, or assigns, or causes the transfer, conveyance, or assignment of, residential mortgage loans, including through a special purpose vehicle, to any securitization vehicle, excluding any trustee that holds such loans solely for the benefit of the securitization vehicle. A “securitization vehicle” would mean a trust, corporation, partnership, limited liability entity, or special purpose entity that: (A) is the issuer, or is created by the issuer, of mortgage pass-through certificates, participation certificates, mortgage-backed securities, or other similar securities backed by a pool of assets that includes residential mortgage loans; and (B) holds those loans.

17 Under S. 2452, the term “mortgage originator” means any creditor or other person, including a mortgage broker, who, for compensation or in anticipation of compensation, engages either directly or indirectly in the acceptance of applications for home mortgage loans, solicitation of home mortgage loans on behalf of consumers, negotiation of terms or conditions of home mortgage loans on behalf of consumers or lenders, or negotiation of sales of existing home mortgage loans to institutional or noninstitutional lenders. It also includes any employee or agent of such person.

18 The Massachusetts Division of Banks defines “home loan” as a loan, other than a reverse mortgage transaction, in which: (i) the borrower is a natural person; (ii) the debt is incurred by the borrower primarily for personal, family, or household purposes; and (iii) the debt is secured by a mortgage on real estate improved with a dwelling designed to be occupied by not more than four families and occupied or to be occupied in whole or in part by the borrower. “Home loan” does not include a loan with a maturity of less than one year, if the purpose of the loan is a bridge loan connected with the acquisition or construction of a dwelling intended to become the borrower’s principal dwelling.

K&L Gates' Mortgage Banking & Consumer Finance practice provides a comprehensive range of transactional, regulatory compliance, enforcement and litigation services to the lending and settlement service industry. Our focus includes first- and subordinate-lien, open- and closed-end residential mortgage loans, as well as multi-family and commercial mortgage loans. We also advise clients on direct and indirect automobile, and manufactured housing finance relationships. In addition, we handle unsecured consumer and commercial lending. In all areas, our practice includes traditional and e-commerce applications of current law governing the fields of mortgage banking and consumer finance.

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