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Memorandum

TO: MBA's Regulatory Compliance Conference
"Secondary Market Developments"
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RE: Final Rule Amending the Home Mortgage Provisions of Regulation Z

We are writing to inform you that on July 14, 2008, the Federal Reserve Board (the "Board") approved a final rule to amend ("Final Rule") Regulation Z, which implements the federal Truth in Lending Act ("TILA"), as amended by the Home Ownership and Equity Protection Act ("HOEPA"). The Board issued the Final Rule pursuant to its rulemaking authority under HOEPA, which authorizes the Board to prohibit acts and practices in connection with mortgage lending that the Board finds to be unfair or deceptive, as well as under its general rulemaking authority under TILA. The Final Rule largely follows the proposed amendments which the Board released in December 2007.¹

Under the Final Rule, among other things, the Board creates protections for a new category of loans called "higher-priced mortgage loans," which are intended to encompass the subprime market. The Board states that the Final Rule achieves four goals: (i) to prohibit certain acts or practices for these "higher-priced mortgage loans" and loans that meet HOEPA's "high cost" thresholds; (ii) to prohibit other acts or practices for *all* closed-end credit transactions secured by a consumer's principal dwelling; (iii) to revise the disclosures required in advertisements for credit secured by a consumer's dwelling and to prohibit certain practices in connection with closed-end mortgage advertising; and (iv) to require disclosures for closed-end mortgages secured by a consumer's principal dwelling to be provided earlier in the transaction. We have set forth below a short summary of each of the salient provisions of the Final Rule.

The Final Rule generally becomes effective on October 1, 2009, except for the escrow requirements. The escrow requirements become effective April 1, 2010, for "higher-priced mortgage loans" and "high cost" loans under HOEPA which are *not* secured by manufactured housing, and on October 1, 2010 for such loans which *are* secured by manufactured housing.

¹ See TPW Memo regarding the Federal Reserve Board's Proposed Mortgage Lending Regulations, dated December 2007.

I. Prohibited Acts and Practices in Connection with “Higher-Priced Mortgage Loans”

In response to the substantially higher default rates for subprime mortgages, the Final Rule creates a new category of loans called “higher-priced mortgage loans,” which are intended to capture the subprime market, but generally exclude the prime market. This new category supplements the consumer protections previously enacted that are applicable to “high cost mortgages” under HOEPA. The Final Rule includes four key protections for this new category of loans, that are described below.

A. Definition of a “Higher-Priced Mortgage Loan”

The Final Rule adopts a definition of a “higher-priced mortgage loan” that is similar to the definition that was previously proposed, but which uses a different index. Instead of yields of Treasury securities, the Board will publish, and the new definition of a “higher-priced mortgage loan” will use, a new survey-based estimate of rates for the lowest-risk prime mortgages, referred to as the “average prime offer rate,” which is based on a survey that is currently published by Freddie Mac.

Under the Final Rule, a “higher-priced mortgage loan” is defined as a closed-end consumer credit transaction secured by the consumer’s principal dwelling where the annual percentage rate (“APR”) on the loan exceeds:

1. For first-lien loans, 1.5% above the average prime offer rate; and
2. For subordinate-lien loans, 3.5% above the average prime offer rate.

“Higher-priced mortgage loans” include home purchase loans, home improvement loans, and refinancings. The Final Rule covers nontraditional mortgages only if their APRs exceed the aforementioned thresholds. Significantly, the definition of a “higher-priced mortgage loan” does *not* include home equity lines of credit. Note that the Final Rule, however, prohibits structuring a closed-end “higher-priced mortgage loan” as an open-end transaction for the purpose of evading the new protections. Loans to investors are also not generally covered by TILA and HOEPA. Please note that this is a very low threshold and will likely encompass virtually all subprime loans as well as a portion of “Alt-A” loans.

In a related move, the Board is publishing for public comment a proposal to revise the definition of “higher-priced mortgage loan” under Regulation C, which implements the Home Mortgage Disclosure Act (“HMDA”), in order to conform to the definition the Board is adopting under Regulation Z. HMDA requires lenders to report price information for such loans.²

B. Prohibited Acts and Practices for “Higher-Priced Mortgage Loans”

As stated, the Final Rule sets forth the following four key protections for these “higher-priced mortgage loans,” as well as for loans that are covered under HOEPA.

² Currently, the reporting thresholds under HMDA are: (i) for first-lien loans, 3% above the yield on comparable Treasuries; and (ii) for subordinate-lien loans, 5% above comparable Treasuries.

1. No Lending Without Regard to Repayment Ability

The Final Rule prohibits creditors from extending a “higher-priced mortgage loan,” including a “high cost mortgage” under HOEPA (“HOEPA-covered loan”), based on the collateral and without regard to the consumer’s repayment ability. Note that significantly, under the Final Rule, there is no longer a requirement to show that a “pattern or practice” of lending without regard to repayment ability exists before a violation will occur.

However, the Final Rule provides that a creditor will be *presumed* to have complied with the ability to repay rule if the creditor satisfies each of three requirements: (i) verifying repayment ability; (ii) determining the consumer’s repayment ability using fully-indexed and fully-amortizing payment (i.e., the highest payment), except in certain specified circumstances, and considering other mortgage-related obligations such as property taxes and homeowner’s insurance; and (iii) assessing the consumer’s repayment ability using one of the following measures; a ratio of total debt obligations to income, or the income the consumer will have after paying debt obligations. Please be advised that with respect to the foregoing clause (ii) concerning the fully-indexed and fully-amortizing payment, the Final Rule provides that a creditor may use a discounted initial rate if this rate is fixed for at least 7 years. If the loan has a stepped-rate, the rate specified is the highest possible in the 7 years following consummation.

2. Required Verification of Income and Assets

Creditors are also prohibited from relying on amounts of income, including expected income, or assets to assess repayment ability for a “higher-priced mortgage loan” or HOEPA-covered loan without verifying such amounts. The Final Rule specifically authorizes a creditor to rely on W-2 forms, tax returns, payroll receipts and financial institutions records such as bank statements.

In addition, the Final Rule includes an affirmative defense for creditors who fail to verify income or assets if they can show that the amounts of the consumer’s income or assets the creditor relied on were not materially greater than what the creditor could have documented at loan closing.

3. Restrictions on Prepayment Penalties

The Final Rule prohibits a prepayment penalty with a “higher-priced mortgage loan” or a HOEPA-covered loan if payments can be changed during the four-year period following consummation, such as in a 2/28 or 3/27 adjustable rate mortgage. Further, for other “higher-priced mortgage loans” or a HOEPA-covered loans (i.e., loans whose payments cannot change for four years following consummation), the Final Rule provides that: (i) the prepayment penalty period may not exceed 2 years; and (ii) the penalty must not apply in the case of a refinancing by the creditor or its affiliate.

4. Required Escrows for Payment of Taxes and Insurance

The Final Rule prohibits creditors from making a first-lien “higher-priced mortgage loan” without establishing an escrow account for property taxes and homeowner’s insurance premiums. The Final Rule permits, but not require, creditors to offer borrowers the opportunity to “opt out” of, or cancel, the escrow arrangement twelve months after consummation.

II. Prohibited Acts and Practices for All Closed-End Credit Secured by a Principal Dwelling

In an attempt to address other perceived problems with the residential mortgage market as a whole, not just within the subprime market, the Final Rule also set forth other prohibited acts and practices which apply to *all* consumer closed-end credit secured by a consumer’s principal dwelling, regardless of whether the loan is a “higher-priced mortgage loan” or a HOEPA-covered loan. These prohibitions do *not*, however, apply to open-end home equity plans.

Further, significantly, the Final Rule *does not* incorporate the proposal that would have prohibited creditors from paying mortgage broker compensation (yield-spread premiums), unless certain disclosures had been provided by the broker in a timely manner to the consumer.

A. Prohibition Against Coercion of Real Estate Appraisers

Creditors and mortgage brokers are prohibited from coercing, influencing or encouraging an appraiser to misrepresent the value of a consumer’s principal dwelling. The Final Rule also prohibits creditors from extending credit when a creditor knows, or has reason to know, at or before loan consummation, that a person has coerced, influenced or encouraged an appraiser to misstate the value of a consumer’s principal dwelling, unless the creditor acts with reasonable diligence to determine the appraisal does not materially misstate or misrepresent the value of such dwelling. The Final Rule applies to all TILA creditors and mortgage brokers.

B. Prohibition Against Abusive Servicing Practices

The Final Rule prohibits servicers from engaging in four potentially abusive servicing practices with respect to consumer credit transactions secured by a principal dwelling. First, servicers are prohibited from failing to credit a payment to a consumer’s account as of the date of receipt, except when a delay does not result in any charge to the consumer or a report of negative information to the consumer reporting agency. Second, servicers may not charge a late fee or other delinquency charge when the only delinquency is attributable to late fees or delinquency charges assessed on an earlier payment and the payment is otherwise a full and timely payment for the applicable period. Third, the Final Rule prohibits the practice of “pyramiding” late fees. Finally, servicers must deliver an accurate payoff statement within a reasonable time after receiving a request from the consumer.

III. Advertising

The Final Rule provides that for both open and closed-end mortgage credit, advertisements provide accurate and balanced information that is not misleading or deceptive, in a clear and conspicuous manner, about rates, monthly payments and other loan features.

A. Advertisement of Rates or Payments

The Final Rule provides that for both open and closed-end credit transactions, if a rate or payment is included in advertisements, *all* rates or payments that will apply over the term of the loan and the time periods for which those rates or payments apply must be disclosed with equal prominence and in close proximity to the advertised rate or payment.

Further, the Final Rule strengthens the clear and conspicuous standard under TILA as it applies to advertisements. For closed-end mortgage advertisements, the Final Rule prohibits the advertisement of any interest rate lower than the rate at which interest accrues annually.

B. Prohibited Practices for Closed-End Mortgage Advertisements

In addition, for advertisements for closed-end mortgage loans, the Final Rule prohibits the following seven practices:

1. Advertising “fixed” or payments without adequately disclosing that the interest rate or payment amounts are “fixed” only for a limited period of time, rather than the full term of the loan;
2. Comparing an actual or hypothetical consumer’s current rate or payment obligations and the rates or payments that would apply if the consumer obtains the advertised product, unless the advertisement states the rates or payments that will apply over the full term of the loan;
3. Characterizing loan products as “government loan programs,” “government-supported programs,” or otherwise endorsed or sponsored by a federal or state government entity, unless loans are actually so supported or sponsored;
4. Prominently displaying the name of the consumer’s current mortgage lender, without also disclosing the fact that the advertisement is from a mortgage lender that is not affiliated with the consumer’s current lender;
5. Advertising claims of debt elimination if the product advertised merely replaces one debt obligation with another;
6. Falsely creating the impression that the mortgage broker or lender has a fiduciary relationship with the consumer (by using the term “counselor”); and

7. Foreign-language advertisements in which certain information, such as a low introductory “teaser rate,” is provided in a foreign language, while required disclosures are provided only in English.

The Final Rule states that these prohibitions apply to advertisements for all closed-end mortgage loans, but do not apply to advertisements for open-end home equity plans..

IV. Timing of Consumer Disclosures

With respect to timing of disclosures to consumers, the Final Rule requires creditors to provide early good faith estimate disclosures to consumers in both purchase and *non-purchase money closed-end transactions*. Further, the Final Rule prohibits creditors or any other persons from imposing a fee in connection with an application for a closed-end mortgage until after the consumer has received the good faith estimates. This fee restriction does not apply to a reasonable and bona fide fee for obtaining the consumer’s credit history, such as a credit report fee. A consumer is deemed to have received the disclosures three business days after they are mailed.

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TPW