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Federal Reserve Proposes New Regulations in Response to Subprime Issues

By Barry G. Sher, Jodi A. Kleinick and Kevin P. Broughel

In an effort to address fallout from the subprime mortgage meltdown and protect consumers from fraud and deception in the mortgage market, the Federal Reserve this week proposed and asked for public comment on rule changes to Regulation Z, which implements the Truth in Lending Act and Home Ownership and Equity Protection Act. The proposed changes would be prospective and would affect only mortgages made after the rule changes become effective. The proposal would establish a new category and group of protections for "higher-priced mortgages," which would include virtually all subprime loans, apply new protections to mortgage loans secured by a consumer's principal residence regardless of loan price, and tighten regulations on mortgage loan advertising and consumer disclosures. These proposed changes would increase significantly the regulation of home-lending practices, which in turn could expose mortgage lenders and brokers to an increased risk of legal liability. This Client Alert discusses the scope of the proposal and considers some of its potential consequences.

The Proposed Rule Changes Were Devised By The Federal Reserve Board And A Coalition of Mortgage Industry Participants To Protect Borrowers From Unfair Or Deceptive Lending Practices While Trying to Avoid Placing Undue Limits on Responsible Lending Or Consumer Credit

The proposal is the culmination of extensive outreach efforts by the Federal Reserve Board, since the early stages of the subprime meltdown, to consumer advocates, market participants, public officials, individual homeowners and others seeking to increase consumer protection while preserving credit market continuity. The proposal covers a number of mortgage lending issues, including lenders' assessment of consumers' ability to repay loans, no-asset verification mortgages, prepayment penalties and misleading or deceptive advertising practices. These and other issues that comprise the proposal are designed, according to Federal Reserve Chairman Ben S. Bernanke, "with an eye toward deterring improper lending and advertising practices without unduly restricting mortgage credit availability."[1] However, the proposal may have the effect of both cutting off credit to some qualified borrowers and increasing the amount of litigation directed at lenders for alleged violations of certain mortgage practices.

The Proposal Establishes a New Category of "Higher-Priced Mortgage Loans" With Its Own Special Set of Consumer Protections

Under the Federal Reserve's proposal, higher-priced mortgages would include – or – are defined as "consumer-purpose, closed-end loans secured by a consumer's principal dwelling and having an annual percentage rate ("**APR**") that exceeds the yield on Treasury securities of comparable maturity by at least three percentage points for first-lien loans, or five percentage points for subordinate-lien loans." For these higher-priced loans, which would include virtually all subprime loans (and importantly, a number of other loans not previously considered subprime), the proposal would invoke the following protections:

- Prohibit creditors from engaging in a pattern or practice of lending without considering borrowers' ability to repay the loans from sources other than the home's value.

- Prohibit a lender from making a loan by relying on income or assets that it does not verify.

- Restrict prepayment penalties only to loans that meet certain conditions, including the condition that the penalty expire at least sixty days before any possible payment increase.

- Require that the lender establish an escrow account for the payment of property taxes and homeowners' insurance. The lender may only offer the borrower the opportunity to opt out of the escrow account after one year.

In addition, the proposal, which does not apply to lines of credit, "would prohibit creditors from structuring closed-end mortgage loans as open-end lines of credit for the purpose of evading these rules."

Traditional Mortgages Are Also Subject To Increased Regulation

The proposal also adds additional layers of protection for more traditional home mortgages including a plan to:

- Prohibit creditors from paying a mortgage broker more than the consumer had agreed in advance that the broker would receive.

- Prohibit any creditor or mortgage broker from coercing or encouraging an appraiser to misrepresent the value of a home.

- Prohibit certain servicing practices, such as "pyramiding" late fees, failing to credit payments as of the date of receipt, failing to provide loan payoff statements upon request within a reasonable time, or failing to deliver a fee schedule to a consumer upon request.

Mortgage Advertising Would Be Subject To Closer Scrutiny

The proposal seeks to regulate mortgage advertising by prohibiting the following practices for closed-end mortgage loans:

- Advertising fixed rates or payments for loans whose rates or payments can vary.

- Comparing current rate or payment obligations with the rates and payments of an advertised product unless the advertisement disclosed the rates or payments that will apply over the full term of the loan.

- Mischaracterizing non-government mortgage products as government loan programs or government supported.

- Third-party advertising that displays the name of the consumer's current mortgage lender unless the advertisement also prominently discloses that the advertisement is from a mortgage lender not affiliated with the consumer's current lender.

- Advertising that claims debt elimination when the product would merely replace one debt obligation with another.

- Advertising that creates a false impression that the mortgage broker or lender has a fiduciary relationship with the consumer.

- Advertising where certain information, such as a low introductory teaser rate, is provided in a foreign language, while required disclosures are only provided in English.

Consumer Disclosures Must Be Made Earlier, Before The Consumer Pays Any Mortgage-Related Fees

The proposal contemplates that creditors provide transaction-specific mortgage loan disclosures, such as the APR and payment schedules for all home-secured, closed-end loans, no later than three days after application, and before the consumer pays any fees except the fee to obtain the consumer's credit report.

Violations Of Restrictions On Loan Terms And Lending Practices Can Lead to Significant Civil Damages And A Right Of Rescission

The proposal would permit consumers who bring timely actions against creditors for violations of loan term and lending practices to recover: (i) actual damages; (ii) statutory damages in an individual action of up to $2,000 or, in a class action, total statutory damages for the class of up to $500,000 or one percent of the creditor's net

worth, whichever is less; (iii) special statutory damages equal to the sum of all finance charges and fees paid by the consumer; and (iv) court costs and attorneys' fees. A consumer would also have the right to rescind the transaction for up to three years after consummation when the mortgage contains a prohibited provision. This right of rescission would not extend, however, to home purchase loans, construction loans, or certain refinancings with the same creditor. In contrast, violations of the advertising rules would expose the creditor to administrative enforcement but not civil liability.

Some Think the Proposal Does Not Go Far Enough

Despite the number of changes to Regulation Z proposed by the Federal Reserve, certain Democratic members of Congress have already harshly criticized the proposal as not doing enough to protect consumers from predatory lending practices. Various consumer advocates have commented that the proposed changes provide no relief for current homeowners. Senator Christopher Dodd, Chairman of the Senate Banking Committee, stated the Federal Reserve's proposed moves amounted to "a clear signal that legislation is necessary to help protect homeowners from abusive and predatory lending practices."[2] Senator Dodd also stated that the Federal Reserve should have proposed prohibiting prepayment penalties on all subprime loans, rather than prohibiting the prepayment penalty only during the 60 days before the loan resets to a higher rate.[3] Representative Barney Frank, Chairman of the House Committee on Financial Services, was more blunt, stating that the proposal confirmed that "one, the Federal Reserve System is not a strong advocate for consumers, and two, there is no Santa Claus."[4] Democratic leaders including both Dodd and Frank indicated they planned to proceed with their own, more aggressive legislative plan to further tighten regulation of the mortgage industry.[5]

Banking Industry Response was Mixed, With Concerns About Overly Restrictive Regulation Unnecessarily Limiting Consumer Credit To Qualified Borrowers

Mortgage lenders, while not as critical as Democratic members of Congress, also raised concerns about the proposal. The American Financial Services Association found the proposal "measured" but also said it needed to determine "whether it might limit product options for too many Alt-A and prime borrowers."[6] The Independent Community Bankers of America called the proposal "an important step in putting an end to predatory lending" but found the definition of high-cost mortgages "problematic" by "cover[ing] many more loans than … [should] be covered, unnecessarily further restricting credit."[7] Similarly, The American Bankers Association expressed "worry that replacing important lending flexibility with rigid formulas might also limit lending to some creditworthy borrowers" and "that some of the product restrictions could make it harder for bankers to tailor products for their customers and communities and result in some creditworthy customers not being able to obtain a loan."[8]

The Proposal's Impact On The Lending Industry Is Uncertain, But Will Likely Increase The Likelihood Of Litigation As Regulation Tightens Around The Industry

Because the proposal is subject to public comment for a 90-day period, evaluating its potential impact on the mortgage market is difficult. Nevertheless, the proposal makes clear that the Federal Reserve will be taking a more active role in regulating the mortgage industry for any perceived predatory or misleading lending practices. As various banking associations have already stated, this increased regulation may significantly dampen the lending industry's appetite for extending credit to subprime borrowers, thereby limiting credit to consumers who ordinarily would be candidates for subprime mortgages. This, in turn, will reduce the number of subprime loans in the marketplace. In addition, the proposal extends beyond subprime loans, covering any mortgage loan with APRs 3% (or 5%) above comparable treasury securities, thus affecting not only subprime borrowers, but others where higher cost loans might otherwise be appropriate.

The proposed rule takes aim at yield-spread premiums, a subject of much past litigation and controversy, as well as the relationships between lenders and appraisers. It is now prohibited for a lender or broker to "coerce" or "encourage" an appraiser to misrepresent the value of a home. This is the subject of ongoing investigations in New York and other states.

Moreover, although some of the new proposed requirements are relatively clear (for example, requiring the lender to establish an escrow account for payment of property taxes and homeowners' insurance) others are open to interpretation, such as the prohibition against creditors engaging in a "pattern or practice" of lending without considering the borrowers' ability to repay loans. In that case, the Federal Reserve refused to adopt a quantitative standard for determining the existence of a pattern or practice, but instead said that each case would depend on the totality of the circumstances. This, along with other regulations, exposes mortgage lenders to additional financial and legal risk, possibly further dissuading them from offering subprime loans to the public. As public comment begins on the proposal, it remains to be seen whether the Federal Reserve will adjust the rules further as it seeks to strike the right balance between protecting consumers and permitting lenders to extend credit to subprime borrowers without unnecessarily restricting mortgage credit.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Atlanta

John L. Douglas
404-815-2214
johndouglas@paulhastings.com

New York

Jodi A. Kleinick
212-318-6751
jodikleinick@paulhastings.com

Washington, DC

James D. Wareham
202-551-1728
jameswareham@paulhastings.com

Chicago

Richard A. Chesley
312-499-6050
richardchesley@paulhastings.com

Keith Miller
212-318-6005
keithmiller@paulhastings.com

New York

Barry G. Sher
212-318-6085
barrysher@paulhastings.com

James R. Bliss
212-318-6626
jamesbliss@paulhastings.com

1 Statement of Ben S. Bernanke, Chairman of the Federal Reserve Board (Dec. 18, 2007).

2 Statement of Senator Dodd, Chairman of the Senate Banking Committee, in Reaction to Proposed Fed. Housing Rules (Dec. 18, 2007).

3 Id.; see also Damian Paletta and James R. Hagerty, Fed's New Rules on Mortgages Draw Hostility, The Wall Street Journal, Dec. 19, 2007.

4 Statement of Representative Barney Frank, Chairman of the House Committee on Financial Services, on Federal Reserve's Proposed Rules on HOEPA (Dec. 18, 2007).

5 Damian Paletta and James R. Hagerty, Fed's New Rules on Mortgages Draw Hostility, The Wall Street Journal, Dec. 19, 2007.

6 Statement from Chris Stinebert, President and CEO, American Financial Services Association (AFSA) Regarding the Federal Reserve's Proposed Regulations For HOEPA (Dec. 18, 2007).

7 ICBA Statement on Federal Reserve's Proposed Rule on 'Higher Priced' Mortgages (Dec. 18, 2007).

8 ABA Statement on Federal Reserve's New Mortgage Lending Proposal by Edward L. Yingling, ABA president and CEO (Dec. 18, 2007).