ReedSmith

March 2002
Bulletin 02-14

# Complying with the New Pennsylvania Subprime Lending Law

*If you have questions or would like additional information on the material covered in this Bulletin, please contact the author:*

*Jonathan L. Levin*
*(Philadelphia)*
*215.851.8138*
*jlevin@reedsmith.com*

*…or the Reed Smith attorney with whom you regularly work, or any of the following:*

*Leonard A. Bernstein*
*(Princeton)*
*609.520.6005*
*lbernstein@reedsmith.com*

*Barbara S. Mishkin*
*(Philadelphia)*
*215.851.8145*
*bmishkin@reedsmith.com*

*Christopher Zettlemoyer*
*(Harrisburg)*
*717.257.3048*
*czettlemoyer@reedsmith.com*

Compliance with Act 55 of 2001, Pennsylvania's revised and expanded Mortgage Bankers and Brokers and Consumer Equity Protection Act (the "Act"), and particularly Chapter 5 on so-called "predatory lending," becomes mandatory on June 25, 2002. This brings both good news and bad news for lenders, brokers and others involved in the residential mortgage lending process.

## Preemption

In the spring of 2001, the Philadelphia City Council took the unprecedented step of passing an ordinance targeting what it identified as "predatory" residential lending. Primarily covering the lending activities of non-banks and bank affiliates, the ordinance was one of the most restrictive and burdensome laws of its kind. Because of its extreme provisions, the ordinance galvanized opposition from many sectors, and in response the Pennsylvania legislature moved quickly to exercise its preemptive powers.

The good news is that, since enactment of the Act on June 25, 2001, no municipality has had the power to establish or enforce rules affecting the lending activities of regulated financial institutions, including banks, thrifts, credit unions, mortgage bankers and mortgage brokers. The new law also recognizes that the subprime lending market "performs a significant service to citizens of this Commonwealth, particularly those in distressed urban areas." Moreover, it affirms that the subprime lending market has only a "relatively few lenders who are purposefully engaged in patterns and practices of unfair treatment to vulnerable consumers." Accordingly, the legislature believes that any restrictions and penalties targeting predatory lenders should not affect "legitimate conventional and subprime markets."

## Covered Loans

The bad news is that Chapter 5 of the Act imposes a raft of new restrictions, prohibitions, remedies and penalties on high-cost closed-end loans made within the Commonwealth, referred to as "covered loans." Covered loans, by definition, are explicitly aligned with loans governed by the Home Owners Equity Protection Act ("HOEPA") and Section 32 of Federal Reserve Regulation Z. The only distinction between coverage of the Act and that of federal law is that a covered loan must have an original principal balance of less than $100,000.

In December 2001, the Federal Reserve Board, which interprets Regulation Z, adopted amendments to Section 32 that broaden the scope of mortgage loans subject to HOEPA. Compliance with these amendments becomes mandatory as of October 1, 2002. HOEPA covers closed-end home equity loans that meet either a rate trigger or a fee trigger. The amendments reduce the rate trigger for first lien loans from an APR which exceeds the rate for Treasury securities with a comparable maturity by more than 10 percentage points, to an APR which exceeds that rate by more than 8 percentage points. (Subordinate lien loans continue to have a 10-percentage-points APR trigger.)

A loan is also covered by HOEPA if the points and fees paid by the consumer exceed the greater of 8 percent of the loan amount or an annually adjusted amount, currently set at $480 for 2002. While the amendments did not change the amount of the fee trigger, they changed the types of charges that are counted as “points and fees” for purposes of applying the fee trigger. Specifically, the amendments added premiums or other charges for credit life, accident, health or loss-of-income insurance or debt cancellation coverage to the charges counted as “points and fees.” (Prior to the amendments, such premiums and charges would only have counted as “points and fees” if the insurance or coverage was required by the lender.)

## New Prohibitions and Limits

The core of Chapter 5 limits the terms of covered loans and restricts related acts and practices in the following ways[1]:

- *No balloon payments:* No payment on a covered loan may be more than double the amount of the average monthly payment. This prohibition applies only for the *first 10 years* of a covered loan.
- *No debt acceleration:* A lender has no right to “call” a loan (make it due and payable) at its sole discretion. This prohibition does not apply in the event of a loan default, by operation of a due-on-sale clause, or where the borrower acts fraudulently or jeopardizes the loan collateral or the lender’s rights.
- *No negative amortization:* A lender may not contract for periodic payments that cause the principal balance of a covered loan to increase. This prohibition does not apply to the workout of a problem loan to which the borrower agrees.
- *No-default interest rate:* A lender may not contract for an increase in the interest rate upon default of a covered loan. This prohibition does not affect a lender’s right to contract for periodic changes in variable-rate covered loans.
- *No payments from proceeds:* No covered loan may provide that any periodic payment will be paid in advance out of the loan proceeds.
- *Limited prepayment fees:* Subject to other applicable law on prepayment fees, a lender may charge a prepayment fee on a covered loan only during the first five years of the loan, and such a fee may be charged only when the lender offers the borrower the alternative of taking a loan without a prepayment fee. A lender may not charge a prepayment fee on a covered loan that refinances a covered loan that the lender currently owns.[2]
- *Mandatory cautionary notice:* A lender may not make a covered loan unless it (or a mortgage broker) gives a prescribed written notice to the borrower at least three business days before closing. This notice is different from the notice required by HOEPA.

---

1 Except where specifically required, the Act does not appear generally to mandate prescribed language or disclosures as part of loan documentation.

2 This provision does not modify or supersede the existing prohibition in Act 6 (the Pennsylvania usury law) on residential mortgage loans up to $50,000, subject to any preemption authority available to lenders under the federal Alternative Mortgage Transaction Parity Act.

- *Consideration of repayment ability:* A lender may not engage in a *pattern or practice* of making covered loans based solely on the value of loan collateral and without due regard for the borrower's ability to repay the loan (*e.g.,* based on income, other obligations, employment, etc.). This prohibition applies only to covered loans made to borrowers with income less than 120% of the median family income established for the lender's region by the U. S. Census Bureau.
- *No points on refinancing (anti-flipping):* A lender may not charge points on a covered loan it makes to refinance an existing covered loan it holds where the existing loan was made within the past year. This prohibition does not prevent a lender from charging points on any proceeds in excess of the current principal balance of the existing loan.
- *No low-rate loan refinancing:* A lender may not refinance, consolidate or replace with a covered loan any zero- or low-interest (at least 2% below current, comparable-term U.S. Treasury securities yield) loans made by government or nonprofit lenders within the first 10 years of the term of such loans.
- *No direct payment to home improvement contractors:* A lender must pay a home improvement contractor from the proceeds of a covered loan only by a written instrument payable to the borrower alone or the borrower jointly with the contractor. A borrower also may direct the lender to pay a third-party escrow agent under a written agreement signed by the lender, borrower and contractor.
- *Single premium credit insurance limitations:* A lender may not sell individual or group credit life, accident and health or unemployment insurance related to a covered loan on a prepaid single premium basis unless it first offers the borrower a monthly premium option, provides a prescribed cautionary notice before or at loan closing, and assures that the borrower may cancel the policy within 30 days after loan closing and receive a full premium refund. This prohibition does not apply to credit insurance for which the borrower chooses the primary beneficiary (unlike the typical policy that automatically designates the lender), and the requirement to offer a monthly premium option only takes effect 18 months (and potentially an additional 6 months) after June 25, 2001.
- *Quarterly reporting to credit bureaus:* A lender or its servicer must report at least quarterly on the payment history—both favorable and unfavorable—of its covered loan borrowers to a nationally recognized consumer credit reporting agency. The federal Fair Credit Reporting Act has no provision relating specifically to this point.
- *Verification of broker licenses:* A lender must verify that every mortgage broker with whom it deals on covered loans holds a currently effective license or authorization to do business within Pennsylvania. This can be accomplished fairly easily by visiting the Pennsylvania Department of Banking ("DOB") website at *http://www.banking.state.pa.us/StateBank/query.asp*, or an inquiry can be sent via e-mail to *ra-bnknondep@state.pa.us*.

## Enforcement and Penalties

The DOB is given extensive examination, investigatory and subpoena powers under the new law. If it discovers a violation of any provision of Chapter 5, the DOB may levy a variety of administrative penalties. These include (a) imposing a fine of $2,000 per violation plus investigative costs; (b) suspending, revoking or refusing to renew any license; (c) prohibiting or permanently removing any individual from the lending or brokering business in Pennsylvania; (d) issuing a cease-and-desist order and requiring restitution to be paid for actual damages to borrowers; and (e) imposing any other conditions the DOB deems appropriate. The DOB also can seek a court injunction to restrain a person from engaging in predatory lending practices, and it may share any enforcement-related information with other appropriate federal or state regulatory agencies.

### Private Law Suits

Besides the DOB enforcement powers, Chapter 5 also gives borrowers the right to sue lenders and brokers for material violations. Importantly, however, any person engaged in the purchase, sale, assignment, securitization or servicing of covered loans cannot be held liable for violations committed by the originators of those loans.

It is particularly important to understand that mandatory compliance affects covered loans originated on or after *June 25, 2002*. Although the DOB, which is responsible for regulation and enforcement, recognizes that it may not impose penalties for violations until that date, it strongly encourages lenders to comply early and indicates that it will monitor for deficiencies during current examinations. Accordingly, we are advising our clients to initiate their compliance programs as soon as practicable.

### Other Amendments

The Act contains the following other relatively minor amendments:

(1) A nonprofit corporation making no more than 12 mortgage loans per calendar year, among other conditions, is exempt from the Act's licensing provisions.

(2) The nature and operation of the bond required of a mortgage broker is described with more particularity.

(3) The DOB and Real Estate Commission are newly authorized to request and receive records of any kind concerning any applicant for a license.

(4) The DOB also is now entitled to charge a fee to providers of continuing education programs in order to defray the expense of reviewing such programs and providers.

* * * * * * *