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Final Changes to Home Mortgage Rules in Regulation Z (Truth-in-Lending)

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Having been urged by Congress and consumer advocates to use its authority under the Home Ownership and Equity Protection Act ("HOEPA") to adopt regulatory changes to prevent unfair and abusive practices in the residential mortgage loan industry, the Board of Governors of the Federal Reserve System ("Board") has now acted by adopting a final rule that amends Regulation Z to add new consumer protections. The final rule, which also contains amendments to the Official Staff Commentary to Regulation Z ("Commentary"), becomes effective Oct. 1, 2009 (except for new escrow requirements that become effective in 2010).

The changes made by final rule fall into three main categories:

- ***Broad New Rules For "Higher-Priced Mortgage Loans."*** The new rule creates a new category of mortgage loans, called "higher-priced mortgage loans" ("HPMLs"), and gives borrowers obtaining HPMLs added protections. HPMLs are not as costly as "high-cost mortgage loans" that are already covered by HOEPA ("HOEPA Loans"), so even more mortgage loans will now be subject to added consumer protections under the Truth-in-Lending Act ("TILA"). An HPML is defined to include, with certain exceptions, any mortgage loan secured by the borrower's principal dwelling that has an annual percentage rate ("APR") that exceeds by a specified amount a new index named the "average prime offer rate" that the Board will publish. A first-lien loan will be an HPML if it has an APR that is 1.5 percent or more above the average prime offer rate for a comparable transaction, and a subordinate lien loan will be an HPML if it has an APR that exceeds the average prime offer rate for a comparable transaction by 3.5 percent or more. The added protections for HPMLs will also apply to most, if not all, HOEPA Loans, since such loans will now in all probability also fall within the new HPML category.
- ***Fee Restrictions, More Disclosures For Most Closed-End Mortgage Loans.*** The new rule provides additional protections to borrowers of all closed-end mortgage loans secured by the borrower's principal dwelling (regardless of the loan's APR) ("CMLs"); expands the coverage of the TILA requirement to give early disclosures for all CMLs; and restricts the ability of lenders or brokers to impose fees in connection with CMLs before the early disclosures are received by the borrower.
- ***Advertising Limits.*** Imposes new requirements for advertising all mortgage loans covered by TILA.

Our discussion below provides an overview of the most significant changes made to Regulation Z by the final rule. While we also mention certain of the more significant Commentary amendments

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that are part of the final rule, anyone charged with implementing the final rule should review the Commentary amendments in their entirety. The Commentary amendments, as well as the Board's lengthy Supplementary Information that accompanies the final rule, contain important guidance.

"Higher-Priced" Mortgage Loans: Added Protections

Exempt Loans – Certain loans that would otherwise fall within the definition of an HPML are exempted from the HPML protections. These include temporary or "bridge" loans with a term of 12 months or less (such as a loan to purchase a home where the consumer plans to sell his or her current home within 12 months), reverse mortgage loans, and home equity lines of credit ("HELOCs").

Index – According to the Board, the final rule's definition of an HPML will capture virtually all loans in the subprime market and a portion of the "alt-A" market, but will generally exclude loans in the prime market. In its proposal of the new rule ("Proposal"), the Board had proposed a definition of an HPML that used an index based on yields on Treasury securities. Because of concerns that using such an index would cause many prime loans to be subject to the added protections in the final rule, the final rule uses an "average prime offer rate" that is derived from average interest rates, points, and other pricing terms offered by a representative sample of creditors on low-risk mortgages. The Board has stated that for the foreseeable future, it will use pricing terms from the Freddie Mac Primary Mortgage Market Survey to set average prime offer rates. To determine if a loan is an HPML, a loan's APR must be compared with the average prime offer rate as of the date the interest rate is set. (The Board has also proposed to conform its definition of "higher-priced" mortgage loans in Regulation C for HMDA-reporting purposes to make it the same as in the final rule.)

Ability to Pay – For HOEPA loans, TILA currently prohibits a pattern or practice of extending credit based on a consumer's collateral without regard to repayment ability, and creates a presumption of a violation where a creditor has a pattern or practice of failing to verify and document repayment ability. The Proposal would have merely extended these provisions to HPMLs. The final rule, however, removes the "pattern or practice" qualification, with the result that it will now be a violation of TILA for any HPML or HOEPA Loan (other than a HOEPA Loan that is a temporary or "bridge" loan with a term of 12 months or less) to be extended based on the collateral without regard to the borrower's ability to repay from income and assets other than the collateral.

Verification of Income and Assets – Under the final rule, creditors must verify income and assets that they rely on in making HPMLs (in effect, prohibiting "stated income" HPMLs). This is a tougher stance than the Board took in the Proposal, which would simply have extended to HPMLs the current Regulation Z rule for HOEPA Loans that provides that a pattern or practice of failing to verify creates a presumption of a violation. The final rule once again discards the "pattern or practice" qualification, and makes verifying the borrower's repayment ability and current obligations an affirmative requirement for all HPMLs and HOEPA Loans.

Ability to Pay: Presumption of Compliance – The final rule provides that a creditor is presumed to have complied with the requirement to take into account the borrower's repayment ability if the creditor: (1) verifies repayment ability through appropriate documents; (2) determines the consumer's repayment ability using the largest scheduled payment of principal and interest in the first seven years following consummation (which in most cases will require use of the fully indexed rate for variable-rate loans and the fully amortizing payment for loans that permit less than fully amortizing payments), and taking into account property tax and insurance obligations and similar mortgage-related expenses; and (3) assesses the consumer's repayment ability using either a ratio of total debt obligations to income or the income the consumer will have after paying debt obligations. This presumption of compliance, however, is not available for loans with a balloon payment that becomes due in less than seven years, or loans with scheduled payments that cause negative amortization within the first seven years. In addition, this presumption can be rebutted by a showing that the creditor disregarded repayment ability despite following these procedures.

Prepayment Penalties – The final rule significantly restricts the ability of a creditor to include a prepayment penalty provision in an HPML. It allows for the imposition of a prepayment penalty otherwise permitted by law in connection with an HPML *only if*, under the terms of the loan: (1) the penalty will not apply after two years following the closing; (2) the penalty will not apply if the source of repayment is a refinancing by the same creditor or an affiliate of that creditor; and (3) the amount of the periodic payment of principal or interest, or both, may not change during the first four years of the loan term. (If an HPML is also a HOEPA Loan, a prepayment penalty must also meet the additional restrictions that apply to HOEPA Loans.)

Required Escrows – The final rule requires creditors to escrow for property taxes and insurance in connection with first lien HPMLs. The escrow may only be cancelled by a creditor or servicer in response to a consumer's request received no sooner than 365 days after consummation. (Exceptions exist for loans secured by a condominium unit or by shares in a cooperative.)

Evasion – The final rule prohibits an HPML from being structured as an open-end loan to avoid the new requirements for HPMLs.

Penalties; Rescission – Under the final rule, an HPML with a prepayment penalty that does not conform to the new requirements will be subject to the three-year right of a borrower to rescind (unless the HPML is a home purchase loan or another category of loan that is exempt from rescission). Since the new restrictions on HPMLs and CMLs (discussed below) are based on the Board's authority under HOEPA, it appears that violations of those restrictions (as well as the new restrictions for HOEPA Loans), will be subject to civil liability under TILA, including the enhanced statutory damages that are currently available for violations of the existing requirements applicable to HOEPA Loans.

New Protections For All Closed-End Mortgage Loans Secured By A Principal Dwelling

The final rule creates new restrictions that apply to all CMLs without regard to the APR.

Influencing Appraisers – The final rule prohibits any creditor or mortgage broker, as well as any affiliate of a creditor or mortgage broker, from directly or indirectly coercing, influencing or otherwise encouraging an appraiser to misstate or misrepresent the value of a home that secures a CML. The final rule contains various examples of actions that violate and do not violate the prohibition. It also prohibits a creditor who knows there has been a violation of the appraiser coercion prohibition in connection with an appraisal from extending credit based on that appraisal, unless the creditor documents that it has used reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the property's value.

Servicing Rules: Late Fees, Crediting Payments, Payoff Quotes – The final rule also impacts servicers of CMLs. It prohibits servicers from "pyramiding" late fees—imposing a late fee where a full payment has been made on time and the only delinquency is attributable to a late fee assessed on a prior payment. It requires servicers to credit payments as of the date of their receipt, unless the delay does not result in any charge to the consumer or the reporting of negative information to a consumer reporting agency. Notwithstanding the foregoing, if the borrower remits, and the servicer accepts, a payment that does not conform to written payment instructions provided by the servicer, the servicer is given up to five days from receipt to credit the payment. The final rule also prohibits servicers from failing to provide payoff quotes within a reasonable time after being requested to do so, and the Commentary amendments that are part of the final rule set forth a safe harbor period of five days after request. An additional prohibition in the Proposal that would have required servicers to provide a fee schedule upon request was not adopted in the final rule.

Mortgage Broker Compensation: Board Defers Action For Now – One of the most significant and controversial changes contained in the Proposal was a requirement that a mortgage broker make an upfront disclosure to its CML customers of the total amount of compensation it will receive in the transaction, both from the borrower

and the lender, and that a creditor not pay a mortgage broker any compensation that would cause the mortgage broker's total compensation to exceed the amount so disclosed. The big news for brokers is that this portion of the Proposal was withdrawn by the Board in the final rule. However, the Board indicated that it would continue to examine options for addressing potential unfairness to consumers associated with broker compensation arrangements, such as yield spread premiums, and would continue to consider possible disclosure or other remedies to such potential unfairness in connection with its ongoing comprehensive review of Regulation Z.

Early Disclosures Required For More Loans; Limits On Up-Front Fees

Regulation Z currently requires a creditor to provide estimated TILA disclosures (an "early-TIL") to a consumer within three business days following receipt of the consumer's application when the mortgage loan is being made to purchase a home that will be the borrower's principal dwelling. The final rule expands this requirement to all CMLs, meaning that early-TILs must also be provided in connection with closed-end refinances, home equity loans and other non-purchase money mortgage loans that are secured by the borrower's principal dwelling. (We note that TILA amendments are included in the Housing and Economic Recovery Act of 2008, signed by President Bush on July 30, 2008. These amendments impose new requirements for the content of an early-TIL, including a statement that receipt of an early-TIL or signing of an application does not require the consumer to complete the loan, and added disclosures for loans in which the interest rate or payments can vary. They also appear to require a lender to wait at least seven business days after sending an early-TIL before closing a loan. And they increase the statutory damages for TILA violations in connection with closed-end home mortgage loans.)

In addition, the final rule provides that for any loan for which an early-TIL must be provided, no fee other than a fee for a credit report may be imposed by a creditor or any other person before the consumer has received the early-TIL. An early-TIL that is mailed to the consumer will be considered to have been received three business days after mailing. The final rule also amends the definition of "business day" in Regulation Z so that for purposes of this presumption, a "business day" will have the same meaning as it does for measuring the three-day rescission period. The Commentary amendments in the final rule provide guidance as to how the fee limitation applies to loans submitted by mortgage brokers. The good news here is that the Board rejected attempts by consumer groups to extend HOEPA civil liablity to violations of the early-TIL requirements.

New Advertising Restrictions

The final rule seeks to eliminate certain misleading advertising practices in evidence during recent years that are thought to have contributed to the subprime crisis.

Open-end Loans **–** The final rule imposes new disclosure requirements when an advertisement for a HELOC contains a "promotional rate" or a "promotional payment." A "promotional rate" is an APR applicable to a variable-rate HELOC that is not based on the index and margin used to make rate adjustments to the plan and is less than a reasonably current APR that would be in effect based on that index and margin. A "promotional payment" for a variable-rate plan means the amount of any minimum payment that is not based on the index and margin used to determine the amount of other minimum payments and, given an assumed balance, is less than the amount of other minimum payments that would apply based on a reasonably current application of that index and margin. For non-variable rate plans, a "promotional payment" means the amount of any minimum payment that is less than the amount of other minimum payments under the plan given an assumed balance.

Under the new rule, each listing in an advertisement of a promotional rate or payment will trigger the need to disclose, in a clear and conspicuous manner "with equal prominence and in close proximity to" the promotional rate or payment, the period of time during which the promotional rate or payment applies, as well as information concerning post-promotional rates or payments. Commentary amendments in the new rule provide

that this additional information will be deemed to satisfy the equal prominence and close proximity requirement if it is in the same type size and immediately next to or directly above or directly below the promotional rates or payments, without any intervening text or graphical displays.

The Commentary amendments in the final rule include new comments that interpret the existing clear and conspicuous standards for Internet, television and oral advertisements of HELOCs. In addition, the final rule contains a new alternative disclosure option for television and radio HELOC advertisements. Also included in the final rule are new disclosure requirements as to the tax implications of plans for which an advertisement states that the advertised credit can exceed the fair market value of the home. These new disclosure requirements implement provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("Bankruptcy Act").

Closed-end Loans – The final rule amends Regulation Z to add a "clear and conspicuous" standard that specifically applies to all closed-end credit advertisements, and new disclosure requirements and prohibitions that apply to advertisements for closed-end credit that is home-secured.

The final rule provides that the inclusion in an advertisement for a home-secured loan of a simple annual interest rate when more than one simple annual interest rate will apply during the term of the advertised loan, or the amount of any payment, will trigger the need to disclose additional information concerning, respectively, the additional simple annual interest rate(s) and APR or the payment(s). This additional information must be disclosed "with equal prominence and in close proximity to" the advertised rate or payment that triggered the additional information. The Commentary amendments that are part of the final rule clarify the application of the clear and conspicuous standard to Internet, television and oral advertisements of home-secured loans, and also clarify the equal prominence and close proximity requirements that are part of that standard. In addition, the final rule contains a new alternative disclosure option for television and radio advertisements that is modeled after the similar new option for open-end credit.

The final rule only permits the advertisement of a simple annual interest rate in conjunction with the APR for closed-end home-secured loans. Also, for all closed-end credit, it extends the equal prominence and close proximity requirement to advertisements of variable-rate loans that promote an initial discounted rate, and clarifies that when the requirement to disclose the "terms of repayment" is triggered, such terms must reflect the repayment obligations over the full term of the loan, including any balloon payment. Such balloon payment disclosures will also be subject to an equal prominence and close proximity requirement. In addition, to implement provisions of the Bankruptcy Act, the final rule includes new disclosure requirements as to the tax implications of closed-end loans for which an advertisement states that the advertised credit can exceed the fair market value of the home.

The following misleading advertising practices are prohibited by the final rule in connection with closed-end home-secured credit: (1) using the word "fixed" to refer to rates, payments or a loan in an advertisement for variable-rate loans or other loans where the payment will increase unless certain conditions are satisfied; (2) comparing a consumer's current actual or hypothetical rates or payment amounts with the rates or payment amounts available under the advertised loan unless certain conditions are satisfied; (3) misrepresenting that a loan is government-endorsed or sponsored; (4) using the name of the consumer's current mortgage lender in an advertisement, such as a direct mail solicitation, without indicating who is making the advertisement, and that such person is not associated with or acting on behalf of that lender; (5) making misleading claims that a loan will eliminate debt; (6) using the term "counselor" to refer to a for-profit lender or broker; and (7) advertising information about certain trigger terms or other required disclosures, such as an initial discounted rate, in a foreign language while providing information about other trigger terms or required disclosures, such as a fully indexed rate, only in English.

***Civil Liability For Violations* –** Since the new seven prohibitions on misleading advertising practices in connection with closed-end home-secured credit discussed above, like the new HPML and CML protections, are also based on the Board's HOEPA authority, it appears that violations of those prohibitions would also be subject to similar civil liability, including enhanced HOEPA statutory damages. This would represent a particularly significant change since TILA does not now impose any civil liability for violations of the existing Regulation Z advertising requirements, and provides that such violations are subject only to enforcement by federal supervisory agencies.

Impact of Final Rule

While implementing its new requirements will require significant operational changes, the final rule is not likely to bring material change to the marketplace since, in many respects, it is merely a codification of changes in practices that have already occurred. The worst abuses have already been curtailed, primarily as a result of the drastically reduced appetite of secondary market participants for subprime and alt-A loans, in which these abuses are most prevalent, and partially as a result of the Guidance documents put out last year by the federal regulators (and since adopted by most state regulators) regarding subprime lending and non-traditional mortgage loans.

While mortgage lender and broker origination practices are unlikely to be changed significantly by the final rule, the final rule will likely have a significant impact on advertising practices. With little resistance from regulators, some mortgage lenders and brokers in recent years have, in their advertisements and solicitations, regularly described their products and/or made their offers in misleading ways, thereby gaining a competitive edge over other lenders and brokers. Assuming the advertising restrictions included in the final rule are vigorously enforced by regulators, and the potential for civil liability leads to more rigorous compliance, both consumers and reputable lenders and brokers should benefit.

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