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A Mortgage and Consumer Finance Law Update

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Federal Reserve's New Mortgage Lending Rules to Take Effect October 2009

Following months of criticism that federal regulators have been slow to address the subprime mortgage crisis, the Federal Reserve Board ("the Fed") unanimously approved new rules to curb misleading and deceptive practices in mortgage lending, especially subprime loans. The new rules will take effect October 1, 2009.

The rules place particular emphasis on "higher-priced mortgages," a category the Fed is defining on the basis of a new index that it will publish; the index will track the "average prime offer rate" derived from a survey that is currently published by Freddie Mac. This mortgage category captures virtually all subprime loans.

New rules for such mortgages will prohibit lenders from making loans without considering a borrower's ability to repay from income and assets other than the home's value. This provision "effectively giv[es] wronged consumers a private right of action without demonstrating that their case was part of a broader pattern," said Federal Reserve Board Member Randall Krozner, as reported by the *Washington Post*. Without this change, "[i]t would have been difficult otherwise for borrowers to make the case for deceptive practices," said Deborah Goldstein, executive vice president of the Center for Responsible Lending, as reported in *The New York Times*.

While some consumer advocates have pushed to eliminate prepayment penalties altogether, the new rules do not go that far. Instead, lenders will be prohibited from imposing prepayment penalties if the payment can change during the initial four years of the loan. The lender must also establish an escrow account for the payment of property taxes and homeowners' insurance on first-lien homes, but borrowers may have the option to cancel such escrow accounts after the first year.

For all closed-end mortgages secured by a consumer's principal dwelling, the rules prohibit lenders from failing to credit a payment on the date the payment is received, failing to provide payoff statements within a reasonable time and "pyramiding" late fees. Creditors and brokers will be prevented from coercing or encouraging appraisers to misrepresent the value of a home, and creditors must provide good faith estimates of loan costs, including a payment schedule, within three days after a consumer applies for a mortgage loan.

Certain advertising practices will also be prohibited, including representing that a rate is "fixed" when it can change.

The purpose of the new rules package is to "protect consumers from unfair or deceptive ... practices ..., while keeping credit available to qualified borrowers and supporting sustainable homeownership," said Federal Reserve Chairman Ben Bernanke in a press release. Vowing to vigorously enforce the new rules, Bernanke said the new rules are intended to "level the playing field for lenders and increase competition in the mortgage market, to the ultimate benefit of borrowers."

One area of contention that the new rules did not address is the practice of incentive-based pay, known as "yield spread premiums;" The Fed is expected to consider that issue at a later date.

Some consumer advocates criticized the rules for leaving open certain avenues for abusive behavior by lenders, but Representative Barney Frank, chairman of the House Financial Services Committee, credited the Fed for producing rules that exceed the agency's original proposals released in December. Changes from the original proposals resulted from more than 4,500 comments that came from community groups, industry representatives and consumer advocates.

What this Means for Mortgage Brokers and Lenders

Most mortgage brokers and lending institutions have already dramatically altered their lending practices in response to the subprime crisis, so many lenders may already find themselves in compliance with the new standards. However, the new rules are designed to prevent lenders from returning to some older practices when the housing market regains its footing.

In addition, the new rules provide a basis for private causes of action for deceptive practices without the burden of demonstrating a pattern of such abuses, which will increase litigation risks for lenders. While the controversial practice of "yield spread premiums" was not addressed in this latest package, it's a near certainty that the Fed will take up that issue in the future.

Resources

The Federal Reserve's New Rules (Regulation Z) and Staff Commentary may be downloaded at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080714a1.pdf>.

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