CLIENT ALERT

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Rhode Island Residential Lending Update

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Two recent developments further impact the ever-shifting residential lending landscape in Rhode Island: the promulgation of regulations under the *Rhode Island Home Loan Protection Act* (the "Act") and amendments clarifying the City of Providence predatory lending ordinance.

EMERGENCY REGULATION 3 RHODE ISLAND HOME LOAN PROTECTION ACT

On December 30, 2006, the Rhode Island Department of Business Regulation, Division of Banking promulgated *Emergency Regulation 3* ("Regulation 3") to implement the Act, R. I. Gen. Laws § 34-25.2-1 *et seq*. The Act was passed during the 2006 session of the General Assembly and became effective on December 31, 2006. Compliance with Regulation 3 is required immediately, although the Department has stated it will not take any enforcement action relating to required disclosures prior to March 1, 2007. As Regulation 3 is an "emergency" regulation, it is effective for 120 days (until April 30, 2007) unless sooner replaced with a revised emergency regulation or, following notice and a comment period, a permanent regulation.

The Department of Business Regulation has received a number of questions and comments about Regulation 3, particularly about requirements imposed by Regulation 3 that are new and not part of the Act. A number of conduit lenders have announced that they are withdrawing from the Rhode Island market, and it is hoped that revisions to Regulation 3 may eliminate or curtail certain requirements of the regulation and provide further clarity to the Act so that creditors subject to the Act are able to comply with its requirements

while still providing credit opportunities to borrowers who do not qualify for conventional financing.

Residential creditors need to be aware of three important areas covered by Regulation 3: (1) the imposition of mandatory disclosure requirements not contemplated by the Act; (2) the imposition of new record-keeping requirements; and (3) clarification of certain provisions of the Act. Creditors should familiarize themselves with Regulation 3 and establish procedures to meet the new record-keeping and disclosure requirements.

Mandatory Disclosure and Record-keeping Requirements

Application Disclosures

All home loan applicants must be given completed Disclosure Form 1 (prohibited acts and practices -- all home loans) and Form 2 (prohibited acts and practices -- high-cost home loans) found in the Appendix to Regulation 3 within three days of application. Significantly, loan brokers, lenders and applicants must sign Disclosure Forms 1 and 2, and copies of the fully-executed disclosures must be maintained in each loan file. In the absence of further clarity under Regulation 3, creditors should provide these disclosures within three calendar days of application.

Record-keeping Requirements - Home Loans

The Act prohibits flipping a home loan unless the new home loan provides a tangible net benefit to the borrower. "Flipping a home loan" is defined in the Act as the making of a home loan that refinances an existing home loan that was consummated within the prior sixty months when the new home loan does not have reasonable tangible net benefit to the borrower. A "tangible net benefit" exists under the Act if one or more of the following circumstances is present in connection with the refinancing of a home loan: (1) the new monthly payment will be lower, taking into account the fees and costs associated with the new loan; (2) there is a beneficial change in the amortization period of the new loan; (3) the borrower receives cash in excess of the costs and fees related to the refinancing; (4) new home loan has a lower interest rate than the loan being refinanced; (5) there is a change from an adjustable to a fixed rate; or (6) the refinancing is necessary to meet a *bona fide* personal need or court order.

Regulation 3 requires that each person subject to the Act maintain documentation supporting and substantiating the tangible net benefit analysis for each loan. In addition, each person subject to the Act must maintain a list of all home loans where the tangible net benefit analysis has been assented to by the borrower, and documentation identifying and substantiating the tangible net benefit that existed at the time the home loan was consummated. Regulation 3 requires that the analysis performed must be accurate and reflect verified information. The individual authorizing the loan after reviewing the tangible net benefit analysis must sign and date the written record of the analysis by confirming whether he or she has reviewed the analysis.

For home loans subject to the anti-flipping requirements, creditors must provide the applicant with Disclosure Form 3 (description of tangible net benefit) found in the Appendix "as soon as it is determined by the Creditor that the applicant/borrower may fall under the prohibition, but no later than ten (10) business days prior to closing of the loan". Disclosure Form 3 must be signed and dated by the loan broker, lender and borrower, and a copy of the fully-executed Disclosure Form 3 must be maintained in each loan file.

Record-keeping Requirements - High-cost Home Loans

The Act imposes additional limitations and prohibits certain practices in connection with high-cost home loans. These include, among others, prohibitions against (1) charging points and fees in excess of five percent of the total loan amount or $800, whichever is greater; (2) including prepayment penalties in the loan documents; (3) providing for a scheduled payment that is more than two times

larger than the average of the earlier scheduled payments; (4) providing for negative amortization; (5) providing for a default interest rate; (6) financing more than two periodic payments; and (7) imposing a late fee of more than three percent or charging a late fee in certain circumstances.

Persons subject to the Act are required to maintain documentation supporting and substantiating whether or not a particular loan is a high-cost home loan. The high-cost home loan analysis must be accurate, reflect verified information and must be provided to the borrower. In addition, each person subject to the Act must maintain a list of loans where the high-cost home loan has been assented to by the borrower. Regulation 3 also provides that failure to clearly identify, document and substantiate the respective high-cost home loan prior to consummation will be deemed a violation of Regulation 3 and the Act. The individual authorizing the loan after reviewing the high-cost home loan analysis must sign and date the written record of the analysis by confirming the analysis and confirming whether or not the loan is a high-cost home loan.

Applicants who are applying for a high-cost home loan must be provided with Disclosure Form 4 "at such time that it is determined by the Creditor and loan broker that the new loan is a 'high-cost home loan', but no later than ten (10) business days prior to closing of the loan". Disclosure Form 4 must be signed and dated by the loan broker, lender and borrower, and a copy of the fully-executed Disclosure Form 4 must be maintained in each loan file.

We found an ambiguity in Section 5(A)(ii) of Regulation 3, which discusses the record-keeping and disclosure requirements for high-cost home loans. This sub-section contains a statement that "The creditor is required to maintain on file and be in possession of documentation clearly identifying and substantiating the 'tangible net benefit' that existed prior to and at the time the home loan was consummated." This statement implies that a tangible net benefit must be determined for all high-cost home loans, whether or not that loan falls within the flipping a home loan provisions of the Act and Regulation 3. Such a requirement is not found in the Act, and it is possible that the statement was inadvertently placed in Section 5(A)(ii), but we do not have such clarification from the Department on this issue at this time. Persons subject to the Act and Regulation 3 should proceed with caution as it is possible that a tangible net benefit must be found for all high-cost home loans, even purchase money mortgage loans.

Record-keeping Requirements - Bona Fide and Reasonable Fees

If a creditor seeks to exclude certain third party charges as bona fide and reasonable fees in calculating whether points and fees charged in connection with a home loan exceed the "total points and fees threshold" of the Act, Regulation 3 requires that the charges be substantiated by an "invoice or substantially similar document" and that the charges imposed not exceed the invoiced amount. This is a significant requirement since many fees, such as credit report fees, are billed monthly, and other charges, such as appraisals paid at the door or fees of the closing attorney, are reflected on the HUD-1 but have no accompanying invoice. It would appear that failure to maintain the required documentary evidence for a charge means that the entire charge ceases to be a bona fide and reasonable fee, regardless of the nature of the charge, the reasonableness of the amount, or the identity of the payee. If a charge were to exceed the amount on the invoice, it is unclear whether the entire charge ceases to be a bona fide and reasonable fee or whether only the amount in excess of the amount of the invoice is so treated.

Clarifications of the Act

1. Regulation 3 makes clear that references to Rhode Island and federal statutes and regulations refer to those statutes and regulations as amended and in effect at the relevant time.

2. "Bona Fide Discount Points" – Subject to other limitations, up to two bona fide discount points as defined in the Act may be excluded from the points and fees calculations and limitations under the Act. Regulation 3 requires the amount of the interest rate reduction purchased by the discount points to be reasonably consistent with established industry norms and practices for secondary market mortgage transactions. Regulation 3 further establishes a safe harbor by providing that a point is a bona fide discount point if it reduces the interest rate by a minimum of 25 basis points (or ¼ of a point), provided all other terms of the loan remain the same.

3. "Bona Fide and Reasonable Fees" – As noted above, this definition is used in determining whether the points and fees charged in connection with a home loan exceed the "total points and fees threshold" and make it a high-cost home loan. When applying the total points and fees threshold, it is necessary to determine what fees are included as points and fees and what fees are excluded points and fees. Only certain charges may be excluded under the Act and then only if they are bona fide, reasonable and paid to a person other than the creditor or an affiliate of the creditor. Fees that may be excluded are tax payment services fees, flood certification fees, pest infestation fees, appraisal fees, inspection fees, credit report fees, survey fees, attorney fees, notary fees, escrow charges, title insurance premiums, fire and hazard insurance premiums, flood insurance premiums, and premiums for insurance against loss or damage to property.

4. "Creditor" – This is defined in the Act as any person who regularly makes available a home loan, including a loan broker. Regulation 3 provides that a person "regularly makes available" a home loan if, within any consecutive 12-month period, the person originates or extends more than one home loan. A loan broker for an exempt lender would nevertheless appear to be subject to the provisions of the Act.

5. "Current Note Rate" – This is defined as the rate of interest payable by a borrower on a previous home loan. This definition is used in determining whether the interest rate reduction test is met when determining the existence of a tangible net benefit. Importantly, Regulation 3 clarifies that if the previous home loan is an adjustable rate loan, the current note rate is calculated by giving effect to the maximum interest rate adjustment on the previous home loan that would take effect within the 12-month period following the date of application based on market conditions as they exist as of the date of application.

6. "Excluded Points and Fees" – This is defined by Regulation 3 as the items delineated in Section 34-25.2-4(o)(9) of the Act. This clarification is helpful since this term, which is not defined in the Act, is used in the definition of the total points and fees threshold for determining whether a loan is a high-cost home loan. However, this term is also used in clause (i) of Section 34-25.2-4(o)(9) of the Act, which provides that "[i]n no case shall the total excluded points and fees in connection with a home loan exceed three percent of the total loan amount." Presumably, the three percent cap discussed in clause (i) is intended to apply only to the points and fees addressed in clause (i) and not to the other items set forth in clauses (ii) and (iii) of Section 34-25.2-4(o)(9) of the Act. It is hoped that this ambiguity will be addressed by making clear that the definition applies in the context of the points and fees threshold only.

7. "Flipping a Home Loan" – The tangible net benefit provisions of Regulation 3 require that a tangible net benefit exists if the existing home loan was consummated within the prior 60 months "(including the first day of consummation of the loan and the last day of the sixtieth month)". This parenthetical language could mean that the period commences upon consummation of the previous loan and ends on that day, 60 months later. It could also be interpreted to mean that the period ends on

the last day of the 60th full month after the previous loan closed.

8. "Fully Indexed Rate" – This term is new and is used in determining whether a loan is a high-cost home loan by virtue of the rate threshold test under Regulation 3. Unfortunately, the definition has some ambiguities that will hopefully be addressed in a revision to Regulation 3. Most significant, it is defined as "the maximum contract interest rate provided in the loan documents for the home loan, taking into account any adjustable rate feature." This could mean that the rate to be used is the highest rate that could apply during the loan term, taking into account the maximum cap on interest rate adjustments. However, it would seem that this is not what was intended. Regulation 3 also provides that, in taking into account the adjustable rate feature, the contract interest rate should be adjusted using a recent value of the index used for interest rate adjustments under the loan documents taking into account the maximum adjustments permitted and the timing of adjustments required under the loan documents. A recent value of the index is one in effect within the 45-day period prior to consummation. The principles used in calculating the annual percentage rate for a home loan with an adjustable rate feature may be applied in calculating the fully indexed rate. This suggests that what is intended is a composite interest rate, calculated in a manner similar to the calculation of an annual percentage rate for a loan with a discounted initial rate and a variable rate feature.

9. "Home Loan" – Regulation 3 makes clear that the Act applies to a home loan secured by an interest in a manufactured home only if the manufactured home is located or to be located in the State of Rhode Island.

10. "High-Cost Home Loan" – Regulation 3 contains various clarifications of how the tests for high-cost home loans are to be applied:

(a) *Rate threshold*. Regulation 3 makes two clarifications on the application of the rate threshold. First, the interest rate to be used is the fully indexed rate. Second, Regulation 3 makes clear that creditors should look to statistical release H.15 (or its successor) as published by the Board of Governors of the Federal Reserve System in determining whether the loan meets or exceeds the applicable rate threshold.

(b) *Points and fees threshold*. Regulation 3 makes clear that the total loan amount for purposes of determining whether the loan meets or exceeds the points and fees threshold is the face amount of the loan for closed-end credit and the total line of credit for open-end credit.

(c) *Prohibited practices.* Regulation 3 corrects a typographical error in Section 34-25.2-6(a) of the Act making clear that the word "of" is intended to be the word "or" so that the provision should read: "In connection with a high-cost home loan, no creditor shall directly or indirectly finance any points or fees which total is greater than five percent or $800, whichever is greater."

11. "Points and Fees" – Regulation 3 contains various clarifications to the definition of points and fees as used in the Section 34-25.2-4(o) of the Act, including a method for calculating points and fees in connection with open-end loans. In defining what is not included within points and fees, Regulation 3 appears to clarify that Section 34-25.2-4(o)(9)(i) of the Act is intended to permit a creditor to charge, and exclude from the calculation of points and fees, fees paid to federal or state governmental agency for mortgage insurance of up to one percent, prepayment penalties reserved in the loan documents of up to two percent and bona fide discount points of up to two percent subject to a three percent aggregate cap on all such fees.

12. "Previous Loan" – This is defined as the outstanding home loan to be refinanced with the proceeds of a home loan made to the same borrower. This term is used to determine

whether a home loan that is being refinanced is subject to the prohibitions against flipping a home loan. A loan is a previous loan even if there is not complete identity between the obligors on the existing loan (or previous loan) and the new loan, so long as at least one obligor is obligated on both the existing home loan and the new home loan.

13. "Tangible Net Benefit" – Regulation 3 contains various clarifications of how the tests for tangible net benefit are to be applied:

(a) *Lower monthly payment test.* This test addresses how to calculate the borrower's monthly payment to determine whether the payment has been lowered and thereby meets the tangible net benefit test of Section 34-25.2-4(q)(1) of the Act. It will have limited applicability except for fixed rate loans because Regulation 3 requires that the new monthly payment on any loan (other than a conventional fixed rate mortgage) be the payment that fully amortizes the mortgage loan over the term at the highest rate of interest that may be charged under the loan documents during the term of the loan. It is unclear where the support for this position arises under the Act, and it seems more appropriate that this payment should at most be calculated using a composite interest rate. In addition, Regulation 3 provides that points and fees as disclosed on the HUD-1 settlement statement for the loan are taken into account in calculating the new monthly payment by amortizing them over a 24-month period. Points and fees to be so amortized include all points and fees "regardless whether incorporated into and financed through the subject loan."

(b) *Beneficial change in amortization period.* Unfortunately, nothing in Regulation 3 provides guidance as to the meaning of this test for tangible net benefit.

(c) *Current note rate reduced.* Issues also arise in the portion of Regulation 3 that addresses how to determine whether the borrower's current note rate is reduced for purposes of the tangible net benefit test of Section 34-25.2-4(q)(4) of the Act. As noted earlier, Regulation 3 provides a definition of current note rate and that term applies to the previous loan. No guidance is provided for determining the interest on the new home loan if it is not a fixed rate loan. In addition, Regulation 3 provides ambiguous guidance for how to deal with a current note rate that is "subject to a temporary reduction which may be adjusted within six months to one year".

14. Waiver of Homestead Exemption – Regulation 3 clarifies that Section 34-25.2-5(e) of the Act, which prohibits provisions in loan documents that require a borrower to waive any claims or rights, does not prohibit a waiver of the Rhode Island homestead exemption, a waiver commonly required of borrowers in mortgages used in Rhode Island.

CITY OF PROVIDENCE, RHODE ISLAND, AMENDED PREDATORY LENDING ORDINANCE

On December 28, 2006, the Providence City Council passed *An Ordinance Amending the City of Providence Ordinance Chapter 2006-33 No. 245 Regarding City Depository Banks* (the "Amended Ordinance"). The Mayor approved the Amended Ordinance on January 8, 2007. The Amended Ordinance is retroactive to July 11, 2006, which is the effective date of the Predatory Lending Ordinance that was passed by the Council on June 12, 2006 (the "Original Ordinance"). We believe the Amended Ordinance addresses the ambiguities in the previous Ordinance and will help alleviate the adverse impact it had on residential lending in Providence.

The Amended Ordinance prohibits a bank or savings and loan association from being designated as city depositories if it or any of its affiliates is a predatory lender as defined in the Amended Ordinance. No person or business entity is to be awarded a contract with the City if the person, business entity or any of its affiliates is a predatory lender.

"Predatory lender" is defined as a business entity that has made, within the previous 24-month period, predatory loans that comprise either five percent of the total annual number of loans made or 25 individual loans, whichever is less. The City shall consider each lender and affiliate separately in making the calculation, and only residential real estate loans on Providence property will be considered. There is a safe harbor for business entities that demonstrate to the Director of Finance that the entity has discontinued the practice of making predatory loans and has taken steps to ensure it will not make future predatory loans.

"Predatory loan" is defined as a loan that violates any of the provisions of the home loan or high-cost home loan provisions of the Act discussed in Rhode Island Home Loan Protection Act section. The Amended Ordinance also incorporates the other definitions contained in the Act, which will allow persons subject to the Amended Ordinance to coordinate compliance with both the Amended Ordinance and the Act simultaneously. The term "high cost loan", which appeared in the Original Ordinance, has been removed from the Amended Ordinance leaving open an ambiguity because there is no definition of "high-cost loan" in the Act, the defined term being "high-cost home loan". Although unlikely, this could be interpreted to require city bidders to provide information on non-real property loans, in addition to real estate loans.

All persons and business entities that seek to contract with the City are required to submit an affidavit in a form prescribed by the Director of Finance certifying that neither it nor its affiliates is a predatory lender. A person or business entity that is ineligible may seek suspension of that ineligibility by the purchasing agent under specific criteria set forth in the Amended Ordinance. Contracts awarded in violation of the Amended Ordinance may be voided by the City. Significantly, debt obligations issued by or on behalf of the City are not covered by the Amended Ordinance.

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If you have questions about this Client Alert or other lending issues, please feel free to contact James H. Hahn or Patricia Antonelli.

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