ALERTS AND UPDATES

U.S. Financial Reform: Mortgage Reform and Anti-Predatory Lending Act

August 24, 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts *on many of the broad topics addressed by the Act, accessible at* www.duanemorris.com/FinancialReform.

Title XIV of the Act, designated the "Mortgage Reform and Anti-Predatory Lending Act," establishes minimum standards for originating residential mortgages, regulates the compensation of mortgage brokers and expands consumer protections and lender disclosure requirements. It also creates an Office of Housing Counseling within the U.S. Department of Housing and Urban Development (HUD). The amendments in Title XIV become effective six to eighteen months after enactment of the Act.

Standards for Residential Mortgage Loans Promulgated

The Act sets forth certain federal standards for residential home loans, designed to ensure that consumers will be informed and will be able to make their mortgage payments. Many of the new standards set forth below are likely to impact the activities of a "mortgage originator," defined as any person who receives a residential loan application, assists the applicant or negotiates loan terms:

- **Licensing Requirement.** Mortgage originators must be registered and licensed in accordance with applicable state law, and such information must be indicated on all loan documents.
- **Steering Incentives Prohibited.** Mortgage originators cannot steer consumers to a loan they cannot reasonably repay, from a "qualified mortgage" to an "unqualified mortgage" or to any loan that has "predatory characteristics." The definition of a qualified mortgage sets forth a number of requirements, including that regular payments as provided may not increase the principal balance of the loan so that there cannot be any negative amortization; terms do not require a balloon payment; assets and income must be verified and documented; debt-to-income ratios must be met; and points and fees may not exceed three percent.
- **Compensation Restrictions.** Mortgage originators may be compensated only from a formulation based on the principal loan amount, although brokers are allowed incentive payments based on the number of loans generated during any specified period of time. "Yield spread premiums" are prohibited, where a broker is paid for giving a higher interest rate to a consumer in exchange for lower up-front costs.
- **Prepayment Penalties Prohibited or Phased Out.** Prepayment penalties are not allowed for non-qualified mortgages. Prepayment penalties on qualified mortgages cannot exceed three percent during the first year of the loan, two percent during the second year of the loan and one percent during the third year. No prepayment penalty is allowed after the third year of the loan.
- **Truthfulness in Loan Application Process.** Mortgage originators are prohibited from mischaracterizing the credit history of an applicant, the residential mortgage loans available or the appraised value of a residential property.
- **Additional Disclosures Required.** Lenders must provide six months' notice before a hybrid adjustable rate mortgage (ARM) is reset with an estimate of the maximum monthly amount payable and an explanation of other

options available to the borrower, such as refinancing, renegotiation of loan terms, payment forbearance and pre-foreclosure sales. In states such as California with an "anti-deficiency law" (where the borrower under certain conditions is not liable for the shortfall between sales price through foreclosure and outstanding mortgage balance), the lender must describe the protection afforded by the law and its significance to the borrower. Lenders are also required to disclose their policy regarding acceptance of partial payments.

- **Expanded Consumer Protections for High-Cost Mortgages.** The Act lowers the threshold of what constitutes a "high-cost mortgage" to those exceeding 6.5 percent on first mortgages and 8.5 percent for subordinate mortgages – and fees and points exceeding 5 percent of the transaction amount. The Truth in Lending Act is amended to provide that high-cost mortgages may not have balloon payments, accelerated indebtedness, modification and certain other types of fees – and they must provide additional disclosures.
- **Minimum Underwriting Standards for Mortgages.** Lenders must make a "reasonable and good faith determination" that borrowers have "a reasonable ability to repay the loan" based on, among other things, verified credit history, income source and debt-to-income ratio.
- **Appraisal Activity Controls Enumerated.** The use of appraisals is also now further regulated, including such provisions as the requirement of a written appraisal by an independent appraiser before extending credit, a physical property visit in certain circumstances, provision of free copies of the appraisal and a notice of the right to a second appraisal.
- **Penalties for Violating These Rules.** A mortgage originator may be found liable for the greater of actual damages or three times the total amount paid to the mortgage originator, plus costs and attorneys' fees. This type of provision may provide an opportunity for class action lawsuits.
- **Defense to Foreclosure.** Borrowers may assert violations of the Act by the mortgage originator as a defense of recoupment or set off in a foreclosure action.

Office of Housing Counseling Formed at HUD

The Act creates an Office of Housing Counseling within the Department of Housing and Urban Development. The office is meant to facilitate homeownership, mortgage-related and rental-housing counseling. It will establish standards for materials used in such counseling, promote counseling, conduct education programs and provide financial assistance to organizations providing counseling.

Six Studies Ordered Relating to Mortgage Reform

The Act mandates a number of studies and reports relating to mortgage reform, including (1) a study of how best to provide for "widespread use" of shared appreciation mortgages (SAM), where the lender agrees to a lower interest rate in exchange for a share of the appreciated value of the property; (2) a study to determine the effects of the Act on the availability and affordability of credit for consumers; (3) a study of the "root causes of default and foreclosure of home loans"; (4) a study concerning appraisal approaches and valuation models; (5) a study of interagency efforts to crack down on foreclosure scams and "emerging schemes in the loan modification arena"; and (6) a study of the effect on residential mortgage loan foreclosures and the availability of property insurance because of drywall imported from China between 2004 and 2007.

Possible Impact of the Act on Mortgage Lending

Implementation of the Act and its various terms and conditions as outlined above may result in potentially unanticipated consequences. The cost of obtaining a residential mortgage may increase substantially as lenders are required to meet the new disclosure requirements and the new underwriting standards, which could necessitate hiring additional staff and is likely to require more paperwork. Furthermore, the minimum underwriting requirements, as established by the Act, may limit credit availability. Becoming familiar with all of the regulations that will be enacted by the various regulatory parties created by the Act may invariably result in increased costs. It is important to note that Congress determined it should be necessary for a study to be undertaken to determine the effects of the Act on the availability and affordability of credit.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact Kenneth A. Latimer, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.