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A Mortgage and Consumer Finance Law Update

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Federal Reserve Proposes New Mortgage Regulations — Public Comment Period Begins

Responding to increasing pressure from the financial sector and lawmakers, on December 18, 2007, the Federal Reserve released a lengthy proposal that is expected to significantly impact a wide array of mortgage lending practices (see list below). The new regulations are expected to be enacted largely as proposed, but a three-month public comment period may have some influence on the details.

Making an observation that has been a Capitol Hill mantra for several months, Fed Chairman Ben Bernanke noted that "unfair and deceptive acts and practices hurt not just borrowers and their families, but entire communities, and, indeed, the economy as a whole." Federal Reserve Governor Randall Kroszner added, "We believe that these proposals will provide a robust set of protections for consumers."

The proposal marks a sharp role reversal for the Federal Reserve, which has been criticized for failing to prevent the now-rampant mortgage crisis, and failing to address the problem even as the subprime mortgage market collapsed in the summer of 2007. The president and lawmakers on both sides of the aisle have called upon the Fed to exercise its existing authority to regulate the industry.

While the proposed regulations will not apply to more "traditional" mortgages held by borrowers that have good credit, the plan will nevertheless impact almost every sector of the industry. The new rules will apply to all mortgage lenders regardless of whether they are independent mortgage companies, banks, or thrift institutions, and there is no exemption for lenders that are already supervised by federal or state regulators.

Broad application of the proposed rules will be achieved by increasing the number of mortgages subject to the Fed’s scrutiny. Prior rules, based on the Home Ownership Equity Protection Act of 1994 (HOEPA), applied to less than 1 percent of all mortgages because the trigger was set so high: loans with soaring interest rates at least 8 percentage points above prevailing Treasury securities rates. The new rules apply to all "higher-priced" mortgage loans with rates starting as low as 3 percent above Treasury rates. This new threshold would cover all subprime mortgages — accounting for about 25 percent of all mortgages in 2006 — as well as some alternative types of loans, such as "Alt-A" loans, sometimes offered to borrowers with good credit.

The proposed regulations include:

- Mortgage companies must be able to demonstrate that their borrowers can realistically afford their mortgages;
- Lenders must disclose "hidden fees" that are often packaged within interest rates;
- Pre-payment penalties will be allowed only under certain limited circumstances, and no penalty may apply at least 60 days before any possible payment increase;
- Mortgage advertising cannot promote only low "teaser" rates and may be required to provide specific information on rate increases and other loan features;
- Borrowers with poor credit would not be allowed to apply for "stated income" loans, sometimes referred to as "liar's loans"; instead, borrowers must document their incomes by providing tax returns, earnings statements, bank records, and other evidence of ability to pay;
- Lenders must establish escrow accounts to cover property taxes and insurance;
- Creditors would have to provide a good faith estimate of the loan costs, including a schedule of payments, within three days after a consumer applies for any mortgage loan;
- Mortgages with future rates that exceed a borrower's ability to pay would be restricted;
- "Yield-spread premiums," which reward brokers for selling higher-cost loans, would be prohibited for both prime and subprime loans unless the broker obtains the borrower's agreement in writing in advance;
- Creditors and mortgage brokers would be prohibited from coercing a real estate appraiser to misstate a home's value;
- Lenders may not qualify a borrower simply on the basis of their ability to pay initial "teaser" rates;
- Loan servicers would be required to credit consumers' loan payments as of the date of receipt and would have to provide a schedule of fees to a consumer upon request;
- Lenders must provide truth-in-lending disclosures to borrowers early enough to use while shopping for a mortgage; and
- Seven specifically identified advertising practices would be banned as deceptive, including representation that a rate is "fixed" when it can actually change.

Reactions For and Against

As expected, the Fed's recent foray into mortgage industry regulation has garnered both praise and criticism. As reported by *The New York Times*, Deborah Goldstein, executive vice president of the Center for Responsible Lending, faults the plan for being "riddled with loopholes and exceptions that will undermine its effectiveness." Representative Barney Frank, chairman of the House Financial Services Committee, said the Fed was "not a strong advocate for consumers," and Senator Christopher Dodd, chairman of the Senate Banking Committee, blasted the proposal as a "step backward."

However, Dan Lindsey, supervising attorney for the Home Ownership Preservation Project of the Legal Assistance Foundation of Greater Chicago found the plan a "huge step in the right direction.... It's the best thing I've seen of any policymaking entity in a long, long time," reported the *Chicago Tribune*. "[The Fed plan] sets some tough standards, but it appears to take a reasonable and balanced approach that we hope will be workable," said Steve O'Connor, senior vice president of governmental affairs for the Mortgage Bankers Association, as reported in *The Washington Post*.

What This Means for the Mortgage Industry

For those in the mortgage lending industry, the Fed plan marks only the latest in a string of Capitol Hill regulatory efforts. While the proposals appear sweeping, it is likely that many of these regulations would have been undertaken by Congress if the Fed had not shown some initiative.

The Federal Reserve explains that its proposal resulted from "extensive outreach efforts with consumer groups, the financial services industry, lawmakers, and others." As a result, industry observers believe the regulations will be enacted with little modification. The agency, however, has submitted the proposal for public comment — which runs through mid-March 2008 — and it behooves all members of the mortgage lending industry to become familiar with the plan and submit responses.

For More Information

Federal Reserve Press Release:
http://www.federalreserve.gov/newsevents/press/bcreg/20071218a.htm

Federal Register Notice and Request for Public Comment (Details of the Proposal) (832 KB PDF):
http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20071218a1.pdf

To submit comments concerning the Fed proposal, follow the instructions at:
http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.

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