PIERCE ATWOOD LLP
ATTORNEYS AT LAW

Mortgage Lending Reform Provisions of the Dodd-Frank Act Will Bring Sweeping Changes

By Richard P. Hackett and Tom Quinn *

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act"). At nearly 850 pages in length the Dodd-Frank Act is intended to address a wide variety of perceived systemic weaknesses that contributed to the current economic downturn. One of the central pieces of this legislation is the Mortgage Reform and Anti-Predatory Lending Act (the "Mortgage Reform Act"). The provisions of the Mortgage Reform Act, which will become effective no later than January 21, 2014, establish a number of new requirements targeting certain abusive and predatory practices within the industry. While a full discussion of all the mortgage related provisions of the Act are beyond the scope of this article, we will briefly summarize some of the more important aspects of this legislation and the impact they will have on mortgage lending activity.

New Requirements for "Mortgage Originators"

Subtitle A of the Mortgage Reform Act establishes a series of new requirements for individuals deemed to be "Mortgage Originators." A "Mortgage Originator" is defined by the Act to be an individual who takes a residential mortgage loan application, assists a consumer in obtaining or completing such an application or offers or negotiates the terms of a residential mortgage loan. Although some exclusions exist for mortgage loan servicers negotiating loan modifications, real estate brokers and individuals conducting purely clerical tasks, this relatively broad definition conceivably would encompass the day-to-day activities of many bank employees.

If a party is deemed to be a Mortgage Originator, a number of new requirements and restrictions will apply. Specifically:

- Duty of Care: Mortgage Originators will have a duty to be both (a) duly qualified and (b) either licensed or registered under applicable state and federal law, including the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (the "SAFE Act"). Under this duty Mortgage Originators are also responsible for including their unique identifier issued by the Nationwide Mortgage Licensing System and Registry on all loan documents.
- Limits on Mortgage Originator Compensation: The Mortgage Reform Act takes specific aim at yield spread premiums by prohibiting any Mortgage Originators from directly or indirectly receiving any compensation that varies based on the terms of the residential mortgage loan (other than the amount of the principal). Moreover, Mortgage Originators may not receive compensation from any party other than the consumer unless the consumer with whom the Mortgage Originator is dealing has (a) paid nothing to the Mortgage Originator and (b) has paid no upfront fees or points (other than bona fide third party charges to a party that is not affiliated with the Mortgage Originator or creditor). However, Mortgage Originators may be compensation based on the number of loans closed.
- Regulatory Limits on "Steering" and Other Predatory Practices: The Mortgage Reform Act calls for the adoption of regulations intended to prohibit:
  - Steering and Discouragement: Mortgage Originators will be prohibited from steering consumers toward loans that the consumer lacks a reasonable ability to repay or that have certain predatory characteristics (such as equity stripping, excessive fees or abusive terms), or away from "Qualified Mortgages" for which the consumer qualifies toward another non-qualified product. Similarly, these regulations will also prohibit Mortgage Originators from discouraging consumers from seeking more affordable loans from another party if the consumer cannot be qualified by the Mortgage Originator.
  - Practices that Promote Disparities: Mortgage Originators will be prohibited from engaging in any abusive or unfair lending practices that promote disparate treatment based on the race, ethnicity, gender or age of the consumer.
  - Mischaracterizations: Mortgage Originators will be prohibited from mischaracterizing either the credit history of the consumer or the loans available to him/her. There will also be regulatory prohibitions against mischaracterizing (or inducing the mischaracterization of) the assessed value of collateral property.

In addition to these requirements, the Dodd-Frank Act provides for discretionary authority to develop additional

* Richard Hackett and Tom Quinn are partners in Pierce Atwood's Boston office

regulations to prohibit or condition terms, acts or practices that are "abusive, unfair, deceptive, predatory, necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers…."

New Standards for Residential Mortgage Loans

The Dodd-Frank Act takes a number of steps to strengthen mortgage loan underwriting and product development standards. Among other things, the Act requires the adoption of regulations that will obligate creditors to make a "reasonable and good faith determination based on verified and documented information" that the consumer has the ability to repay not only the loan being sought, but also any other loans secured by the same collateral that are known to the creditor, including all applicable taxes, insurance and assessments. When making this determination the creditor must consider the consumer's current and reasonably expected income along with his/her current obligations, debt-to-income ratio, employment status and other financial resources. The value of the equity in the collateral property must be excluded by the creditor when making this determination. Certain limited exceptions are made to these requirements for refinance loans that are made, guaranteed or insured by certain federal government agencies and departments if certain additional requirements are fulfilled.

To ease some of the compliance burden associated with the ability to pay determination requirements, the Dodd-Frank Act establishes certain basic "plain vanilla" repayment terms and underwriting standards that – if followed by the creditor – will establish a rebuttable presumption that the ability to pay requirement has been fulfilled. The terms associated with such a "Qualified Mortgage" product include:

- No negative amortization and except as permitted by regulation no deferred principal payments or balloon payments more than twice as large as the average preceding payments;
- Verification and documentation of the income and financial assets relied upon by the creditor to qualify the consumer for the product;
- For fixed rate loans the underwriting process must be based on a repayment schedule that will fully amortize the loan over its term, taking into account all applicable taxes, insurance and assessments;
- For variable rate loans the underwriting process must be based on the maximum rate permitted during the first five (5) years of the loan and a repayment schedule that fully amortizes the loan over its term, taking into account all applicable taxes, insurance and assessments;
- Compliance with any debt to income ratios that may be set from time to time;
- Points and fees must not exceed three percent (3%) of the total loan amount; and
- Maximum repayment term of thirty (30) years.

These criteria are not set in stone, as the Act provides for the flexibility to add to, subtract from or otherwise revise these criteria if doing so would be necessary to maintain the availability of affordable mortgage credit.

In addition to these steps aimed at underwriting standards and processes, the Mortgage Reform Act also establishes several prohibitions that target specific abusive practices. For one, prepayment penalties will be prohibited on all mortgage loans other than Qualified Mortgages, and will only be permitted on Qualified Mortgages if the product is fixed rate and falls within certain rate limits. When permitted, prepayment penalties are capped at no more than three percent (3%) of the outstanding loan balance in the first year, and then must step down by one percentage point each successive year. Any creditor offering a loan with a prepayment penalty must also offer the consumer a second product without a prepayment penalty as a term of the loan. The Mortgage Reform Act also generally prohibits the financing of single-premium credit insurance products and the inclusion of mandatory arbitration clauses from residential mortgage loans *and* home equity line of credit documents.

New Disclosure Requirements for Residential Mortgage Loans

Supplementing the changes to the underwriting standards are changes to Truth in Lending disclosures. Many of them target adjustable rate mortgages (or "ARMs"), including a new change notice to be sent six (6) months before the initial rate change on a "hybrid ARM." Creditors offering ARM products that will escrow for taxes, insurance and other charges will be required to disclose the amount of both the initial and fully indexed monthly payments of principal and interest along with the amounts due for deposit into escrow for taxes, insurance and other assessments.

All residential mortgage loan transactions (regardless of whether they are ARM transactions) will also be required to include the following additional initial disclosures:

- The aggregate amount of all settlement charges for all settlement services provided in connection with the loan (itemized by amounts that are financed and amounts that are paid in cash);
- The wholesale rate of funds in connection with the loan;
- The aggregate amount of other fees or required payments in connection with the loan;
- The aggregate amount of any fees paid to the Mortgage Originator in connection with the loan, including an itemization of the amount of those fees paid by the consumer and the amount paid by the creditor;
- The total amount of interest that the consumer will pay over the life of the loan, expressed as a percentage of the principal amount of that loan.

It is unclear at this point how these new initial disclosures will interface with existing disclosure requirements under other consumer protection provisions, most notably the disclosures required under the Real Estate Settlement Procedures Act.

In addition to these new initial disclosures, the Mortgage Reform Act will also require creditors and/or servicers to provide residential mortgage customers a monthly statement setting forth (to the extent applicable): the amount of principal on the loan, the current interest rate, the date on which the interest rate may reset or adjust, the amount of any prepayment fee, a description of the late fees, contact information (phone number and email address) for the obligor to receive information regarding the mortgage, and contact information (name, address, telephone number and Internet addresses) for HUD-certified counseling agencies available to consumer. Mortgage loan customers that receive a coupon book with substantially the same information will be exempted from the requirement to receive this form of monthly statement. A model form for this statement will be developed.

Amendments to High Cost Mortgage Rules

The Mortgage Reform Act also makes a series of amendments to the "high cost mortgage" provisions found in the Home Ownership and Equity Protection Act ("HOEPA"). In addition to expanding the coverage of these requirements to include both purchase money and open-end credit plans, it also lowers the pricing thresholds for loans to be considered "high cost," as follows:

- Rate Trigger: From either Treasury + 8.00% (for first lien loans) or + 10.00% (for subordinate lien loans) to a rate equal to the sum of the Average Prime Offer Rate + either 6.5% (for first lien loans) or + 8.5% (for subordinate lien loans).
- Points and Fees Trigger: From the greater of 8% of the total loan amount or $ 579 to 5% of the transaction amount for transactions of $ 20,000 or more or the lesser of either 8% of the transaction amount or $ 1,000 for transactions under $ 20,000.

A third qualification is also added to draw into the high cost mortgage rules those transactions that permit the creditor to charge or collect prepayment penalties that last more than thirty-six (36) months following closing or that charge fees in an amount in excess of two percent (2%) of the amount prepaid.

For those loans that are considered high cost mortgages, the Mortgage Reform Act imposes a series of new limitations. It completely bans prepayment penalties and balloon payments and prohibits creditors from recommending that consumers default on an existing loan or other debt in connection with closing a high cost mortgage loan. Late fees are generally limited to no more than four percent (4%) of the amount past due and not before fifteen (15) days after the payment due date, and the pyramiding of late fees is prohibited. Acceleration of the obligation is limited to payment default, due on sale clauses or other material defaults. The financing of prepayment penalties to refinance a loan held by a creditor (or affiliate) of the high cost loan or of any points and/or fees is prohibited. No fees may be charged for the modification, extension or amendment of a high cost mortgage loan. The Mortgage Reform Act expands the pre-loan counseling required under HOEPA. Additionally, the borrower will be entitled to up to four (4) payoff quotes per year and such quotes must be provided within five (5) business days of the consumer making the request. The creditor may charge a reasonable fee for the transmission of such payoff requests via facsimile or courier, however.

The HOEPA revisions do provide creditors with some relief, however. The Mortgage Reform Act includes a provision by which a creditor or assignee may cure good faith violations by modifying the terms of the high cost mortgage loan to be in compliance with the statutory requirements or otherwise ensure that the loan is in compliance with such requirements. This cure must occur within either thirty (30) days of the closing of the high cost mortgage loan or before the consumer is notified or otherwise becomes aware of the violation. A sixty (60) day cure period is allowed for an unintentional or bona fide error.

Mortgage Servicing

Subtitle E to the Mortgage Reform Act makes a number of changes to the requirements governing the servicing of residential mortgage loans. Under these revisions escrow accounts will be mandatory for closed-end first lien mortgages on principal dwellings where the pricing exceeds certain parameters. Such escrow accounts must be established for a minimum of five (5) years, with the funds held at an insured depository institution or credit union and be subject to state laws regarding interest accrual. The Act also calls for a number of pre-closing disclosures regarding the escrow account, as well as a disclosure for those instances where an escrow account is not mandatory or has been waived by the borrower.

In addition to the escrow requirements, the Mortgage Reform Act also establishes a number of new servicing requirements, including:

- The need to have a "reasonable basis" to believe that the borrower has failed to comply with his/her loan contract requirements (including a series of notifications to be sent to the borrower, with no evidence of insurance received) prior to force placing hazard insurance;
- A ban on charging fees for error resolution services;
- A requirement to take timely action to respond to borrower's requests for error resolution;
- A requirement to promptly credit payments made on a credit transaction secured by the consumer's principal

dwelling (not specifically limited to a particular lien position or product type) as of the day of receipt; and

- A requirement to respond to payoff requests for a "home loan" (a term undefined in the Act) within seven (7) business days of receiving a written request from or on behalf of the borrower.

Appraisal Activities

Finally, the Mortgage Reform Act establishes a number of substantive requirements for appraisal activities. Among other things, these revisions will result in the promulgation of a series of regulations to ensure the independence of appraisals, at which point the Home Valuation Code of Conduct established in late 2008 will sunset. Additional requirements will also be established regarding the portability of appraisals once issued.

Parting Thoughts

As is generally discussed above, the Mortgage Reform Act will result in a number of changes to a wide variety of mortgage practices. Precisely how these requirements will play themselves out remains to be seen. Many of the requirements call for regulatory rulemaking, and the lead time on these regulations is not insignificant. Moreover, Massachusetts is one of a handful of states that have a general exemption from many of the provisions of the Federal Truth in Lending Act sections that are amended by the Dodd-Frank Act. As a result, state-chartered institutions will need to wait further for additional regulatory-rulemaking by the Commonwealth to conform these requirements to the federal rule. In the meantime, all institutions should monitor the manner in which these requirements develop.

© 2010 Pierce Atwood LLP