

# **The Federal Reserve's HOEPA Proposal and Subprime Related Legislation**

by

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After receiving significant pressure from Congress, consumer groups and others, the Board of Governors of the Federal Reserve System issued a proposal that would address a number of the lending practices and concerns arising out of the current subprime lending situation.<sup>1</sup> The proposal would amend Regulation Z, the regulation that implements the Truth in Lending Act, to implement provisions of the Home Ownership and Equity Protection Act ("HOEPA"). Previously, the Federal Reserve issued a regulation requiring the disclosures for high cost loans as defined by HOEPA.

## **Background**

HOEPA was enacted in 1994 to address concerns regarding loans that meet the definition established in the statute for a "high cost" loan that is secured by the consumer's principal dwelling, other than a residential mortgage transaction. Congress was concerned that consumers in particular neighborhoods were targeted by unscrupulous creditors who did not provide sufficient or clear disclosures and who offered loan products with abusive terms. Consumers would enter into transactions with these individuals and frequently lose their homes.

The loans covered by the statute have triggers based on the points and fees charged or on the interest rates charged. The Federal Reserve has the authority to revise the interest rate trigger within limits and the points and fees limitation is adjusted as necessary. Currently, a high cost loan is one that has an annual percentage rate at consummation that exceeds the yield on Treasury securities having comparable periods of maturity by more than eight percentage points for first lien loans, or by more than 10 percentage point for a subordinate lien loan. Alternatively, the total points and fees payable by the consumer at or before the closing exceeds the greater of eight percent of the total loan amount or \$561. The dollar amount is adjusted annually. The Federal Reserve has issued regulations that require disclosures for loans meeting these requirements.

## **Federal Reserve Authority**

The current proposal is considerably broader than the regulations. Under the Truth in Lending Act, the Federal Reserve has the authority to prohibit acts and practices in connection with mortgage loans that the Federal Reserve finds to be unfair, deceptive or designed to evade the provisions of HOEPA. The Federal Reserve may also prohibit acts and practices in connection with refinancing of mortgage loans that the Federal Reserve finds to be associated with abusive lending practices or not otherwise in the interest of the borrower.<sup>2</sup>

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<sup>1</sup> 73 Fed. Reg. 1672 (January 9, 2008)

<sup>2</sup> 15 USC 1639(1)(2)

This authority is broad enough to reach mortgage loans that do not meet HOEPA's rate or fee triggers as well as mortgage loans that are not covered by HOEPA, such as home purchase loans. The authority is not limited to regulating specific contractual terms of mortgage loan agreements, it extends to regulating loan related practices. Finally, the statute authorizes the Federal Reserve to adopt protections against unfair and deceptive practices when such practices are in connection with mortgage loans and protections against abusive practices in connection with the refinancing of mortgage loans.<sup>3</sup> The statute does not establish a standard for what is unfair or deceptive.

## **The HOEPA Proposal**

The proposal goes further than addressing high cost loans; it addresses unfair and deceptive practices for the vast majority of mortgage loans that are secured by a consumer's residence. Among the issues addressed are broker steering, appraisal coercion, unwarranted serving fees, and deceptive advertising. The proposal also has a goal of providing consumers transaction specific disclosures early enough to use while shopping for a mortgage. The Federal Reserve has undertaken a project to test current disclosures and proposed disclosures with consumers. The scope of this proposal extends to all creditors, not simply insured depository institutions.

A number of the provisions in the proposal are similar to or the same as limitations to address practices identified in one or more the issuances of guidance that the agencies have developed over the past two years. However, as a regulation, the provisions will have more force than the guidance previously issued.

Prevention of unfairness, deception and abuse. The proposal includes seven new restrictions or requirements on mortgage lending and servicing that are intended to protect consumers against unfairness, deception and abuse. Some of these restrictions would apply only to higher priced loans and some would apply to all mortgage loans secured by the consumer's principal dwelling. In addition to the specific prohibitions, the Federal Reserve would prohibit creditors from structuring closed end mortgage loans as open end lines of credit for the purposes of evading the rules. The following provisions would apply to higher priced loans:

- Creditors would be prohibited from engaging in a pattern or practice of extending credit without regard to the borrower's ability to repay the loan from sources other than the collateral itself;
- Creditors would be required to verify income and assets on which they rely to make the loan;
- Prepayment penalties would be prohibited unless certain conditions are met; and
- Creditors would be required to establish escrow accounts for taxes and insurance, but borrowers would be permitted to opt out of escrows 12 months after consummation of the loan.

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<sup>3</sup> Id.

The following protections covering closed end loans secured by the consumer's dwelling are in the proposal:

- Creditors are prohibited from paying a mortgage broker more than the consumer had agreed in advance that the broker would receive;
- Any creditor or mortgage broker would be prohibited from coercing, influencing, or otherwise encouraging an appraiser to provide a misstated appraisal in connection with a mortgage loan; and
- Mortgage servicers would be prohibited from pyramiding late fees, failing to credit payments as of the date of receipt, failing to provide loan payoff statements upon request within a reasonable time, or failing to deliver a fee schedule to a consumer upon request.

Mortgage Advertising. The proposal also addresses advertisements for mortgage loans and the Federal Reserve proposes that advertisements for both open and closed end loans provide accurate and balanced information, in a clear and conspicuous manner about rates, monthly fees and other information. The following prohibitions are proposed:

- Creditors would not be permitted to advertise fixed rates or payments for loans whose rates or payments can vary without adequately disclosing that the interest rate or payment amounts are fixed only for a limited period of time;
- Creditors may not compare an actual or hypothetical consumer's current rate or payment obligations and the rates or payments that would apply if the consumer obtains the advertised product unless the advertisement states the rates or payments that will apply over the full term of the loan;
- Creditors may not characterize that loans are part of "government loan programs" or "government-supported loans" or otherwise endorsed or sponsored by a federal or state government entity when the products are not part of a government supported or government sponsored program;
- Creditors may not send solicitation letters that display the name of the consumer's current lender unless the advertisement discloses that the letter is from a lender that is not affiliated with the current lender;
- Creditors may not advertise that debts would be eliminated if the product advertised would replace one debt with another;
- Advertisements may not create a false impression that the mortgage broker or lender has a fiduciary relationship with the consumer; and
- Advertisements that contain certain information in a foreign language would be required to have the disclosures in the foreign language.

The comment period for the proposal closes on April 8, 2008. Seemingly, on a parallel track, Congress continues to debate as to what legislative changes may be necessary. Any final rule issued by the Federal Reserve may have additional restrictions and likely will include disclosures that have undergone consumer testing. Finally, the Federal Reserve has indicated that it will issue a general proposal on unfair or deceptive acts or practices in a few months.

## Subprime Related Legislation

A number of Congressional proposals are being discussed in response to the market turmoil resulting from the problems in the mortgage markets. To date, only one has been signed into law: The Economic Stimulus Act of 2006.<sup>4</sup> In addition to providing a direct fiscal stimulus through tax credits, this legislation is intended to enhance liquidity for larger mortgages by temporarily increasing the size of loans that Fannie Mae and Freddie Mac (GSEs) can securitize to 125 percent of the area mean, up to \$729,750. The Federal Housing Administration (FHA) was also given the authority to insure home loans up to these new limits. However, the increased loan limits for the FHA and the GSEs will expire as of December 31, 2008 unless Congress takes action to extend the program or make it permanent.

With respect to the GSE's, legislation is pending in Congress to provide a permanent increase in the size of the loans that these entities can purchase, coupled with a new regulatory structure that would provide for enhanced Federal oversight of these corporations. H.R. 1427 passed the House of Representatives on May 22, 2007. This bill establishes a new agency, the Federal Housing Finance Agency to examine, supervise and regulate Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The agency is given powers similar to those of the bank regulatory agencies to set capital standards and take enforcement actions for safety and soundness violations. Senate Banking Committee Chairman Dodd has stated that he intends to introduce his version of a GSE reform bill in the near future.<sup>5</sup>

With respect to the Federal Housing Administration, both the Senate and House have passed major reform proposals, and a compromise bill is expected to be ready soon. The House passed bill, H.R. 1852, would allow the FHA to insure mortgages up to \$729,750, with a maximum term of up to 40 years, and without a minimum down payment requirement. A special insurance program is authorized for borrowers with FICO scores of 560 or below. The agency would be authorized to establish a risk-based premium structure. The Senate bill, S.2338, provides that the FHA could insure loans up to \$583,800. The maximum term of the loan would remain 30 years, and the down payment requirement would be reduced from 3 percent to 1.5 percent.

Legislation also passed the House of Representatives to better regulate mortgage lenders. The bill, H.R. 3915, establishes a requirement for State licensing of non-depository mortgage originators, and would require all mortgage originators, including those working for a depository institution, to register with a National Registry. All mortgage originators would have a "duty of care" with respect to consumers, and would have to diligently work to present a range of "appropriate" products to any consumer who inquires about a loan. Anti-steering rules and other restrictions on originator compensation would be mandated.

With respect to lenders, the bill provides that creditors may only make a loan if they have determined that the borrower has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance and assessments. With respect to a refinancing loan, the creditor must also determine that the new loan will provide the borrower with a "net tangible

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<sup>4</sup> Public Law 110-185 (2008).

<sup>5</sup> American Banker, March 7, 2008 page 1.

benefit.” The bill establishes a presumption that certain loans meet these standards. For example, a first mortgage loan that has an APR that does not exceed 3 points over comparable Treasury rates is presumed to be acceptable. Assignees will have liability for loans that violate these standards, unless certain procedures are followed that are designed to prevent an assignee from accepting a loan that does not qualify under certain of the presumptions. However, assignees will always have potentially liability if the original creditor is no longer in existence.

In addition to these proposals, other ideas are being developed to relieve some of the liquidity problems in the mortgage markets. These ideas include resurrecting the Home Owners Loan Corporation (HOLC), which was established in 1933 to purchase non-performing loans in exchange for Government bonds. This Government owned loans were then restructured to provide borrowers lower payments, for example, by extending the maturity date.

Another legislative proposal which seems to be gaining support would be to establish a mechanism to purchase home loans from the creditor or securitization vehicle at a significant discount, provide for an FHA guarantee of the discounted loan, and then sell the loan into the secondary market, e.g. Fannie Mae or Freddie Mac. As part of this program an instrument would be created that would gain value if the home is eventually sold for more than the amount of the mortgage. This instrument, discussed as a “soft second,” would be a method for providing compensation to the FHA for ensuring the discounted loan, or could be used as an incentive for the current holders of these mortgages to sell them at a discount. Some suggest that an auction mechanism could be used in this process to establish the amount of discount that would be required.

An alternative to this proposal would eliminate the need to purchase the loan. Instead, the current holder of the loan, or a third party, could simply refinance the non-performing loan, again at a discount. If the refinanced loan meets certain standards, the FHA would ensure it. Again, a soft second would be created to ensure that any upside potential is allocated to the FHA or other appropriate party.