Client Alert

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# Federal Reserve Board Adopts Significant Revisions to Regulation Z

On July 14, 2008, the Federal Reserve Board (FRB) approved substantial changes to Regulation Z, the implementing regulation of the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA). The FRB described three goals of the amendments: (1) protect consumers in the mortgage market from unfair, deceptive, and abusive lending or servicing practices; (2) ensure accurate mortgage advertising; and (3) provide consumers with information early while they shop for a mortgage.[1] The new rules significantly expand prior regulation by: (i) covering all "higher-priced" mortgage loans instead of only certain specific loans; (ii) covering all mortgage loans secured by a consumers' principal dwelling, even if the lender is not a federally-supervised bank; and, (iii) prohibiting certain practices (such as extending credit without verifying repayment ability) for individual loans without requiring proof that a creditor had engaged in a "pattern or practice" of prohibited conduct.

Most of the amended rules go into effect on October 1, 2009.[2] Highlights of the amended rules are discussed below.

## I. Rules Designed to Prevent Unfair, Deceptive, and Abusive Lending and Servicing

The following new rules apply only to "higher-priced" mortgages, which are defined as first-lien loans that exceed the average rate of prime offers as published by the FRB by 1.5 percent or more, and subordinate-lien loans that exceed the average prime offer rate by 3.5 percent or more:[3]

(i) Creditors are prohibited from extending credit without regard to the borrower's ability to repay. The ability to repay must be based on sources other than just the collateral for the loan, and must take mortgage-related obligations (e.g., taxes and insurance) into account;[4]
(ii) Creditors must verify borrower information regarding repayment ability using third-party documents, and cannot simply rely on the borrowers' "stated income;"[5]
(iii) Prepayment penalties cannot be applied to loans for which payments may change within the first four years of the loan;[6]
(iv) Prepayment penalties can be applied to loans for which payments cannot change within the first four years of the loan, but such penalties can only be applied during the first two years of loans;[7]
(v) Creditors must maintain escrow accounts for property taxes and homeowner's insurance, although the borrower can opt out of the escrow after 12 months.[8]

Significantly, the prohibition on extending credit without regard to the ability to repay applies to each individual loan, with no showing required that a creditor engaged in a "pattern or practice" of doing so.

The FRB's revised rules impose the following additional requirements on all mortgages on consumers' principal dwellings, regardless of whether the mortgage is higher-priced:

(i) Creditors and mortgage brokers are prohibited from coercing, influencing, or otherwise encouraging an appraiser to provide a misstated appraisal;[9]
(ii) Creditors and mortgage brokers are prohibited from extending credit where they know that an appraisal has been tainted by prohibited coercion or influence;[10]
(iii) Servicers must credit a consumer's account as of the date a payment is received;[11]
(iv) Servicers are prohibited from "pyramiding" late fees, that is, charging additional late fees for failure to pay a previous late fee on time;[12]
(v) Servicers must provide consumers with a timely payoff statement upon request.[13]

Regarding the prohibition against coercing, influencing, or encouraging inaccurate appraisals, the FRB lists two examples of prohibited conduct: (i) informing the appraiser of the minimum value needed to approve a loan; or (ii) refusing to use an appraiser for future engagements because of a prior failure to appraise at a minimum amount.

## II. Regulations Relating to Advertising

Regulation Z already requires disclosures in mortgage advertising to be clear and conspicuous. The amended rules require "clear and conspicuous" disclosures to be in close proximity, and be of equal prominence to, the statement that triggers the disclosure.[14]

The revised rules also forbid or limit the following seven specific types of advertisements, which the FRB considers misleading:[15]

(i) use of the term "fixed" in advertisements for loans in which the interest rate or payment amount may change, is permitted only in limited circumstances;
(ii) use of comparison or hypothetical payments and rates is permitted in only limited circumstances;
(iii) suggestions that a loan is government supported or endorsed is prohibited unless the loan is actually endorsed by a government entity;
(iv) use of the name of the consumer's current lender is prohibited unless the advertisement discloses the name of advertising lender and states that the advertising lender is unaffiliated with the current lender;
(v) misleading claims of debt elimination, where a loan actually only replaces one debt with another, are prohibited;
(vi) for-profit lenders are prohibited from using the terms "counselor" in advertisements; and,
(vii) foreign-language advertisements may not contain certain triggering terms (e.g., introductory rates or payments) in a foreign-language where the disclosures required by those triggering terms (e.g., that the introductory rate or payment will change) are provided only in English.

## III. Early Disclosures to Consumers

The revised rules require the lender to make disclosures for closed-end loans to the consumer within three days of a loan application, and before any fees (other than credit check fees) are assessed to the consumer.[16] Previously, disclosures for closed-end loans could be made at any time before the loan was consummated.

## IV. Conclusion

The FRB's changes to Regulation Z are substantial. Although these changes do not go into effect until October 2009, lenders should begin reviewing and modifying their policies and procedures as soon as possible to ensure that necessary changes are made to comply with the new requirements when they take effect.

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1 Until the new rules are published in the Federal Register, they can be found at the FRB's website at: http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080714a1.pdf.
2 The requirements to maintain escrow accounts for tax and insurance payments does not take effect until April 1, 2010 or, for manufactured homes, until October 1, 2010.
3 12 CFR § 226.35(a). At the same time the FRB released the final amendments to Regulation Z, the FRB released a proposed amendment to Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). The proposal would expand the types of loans for which creditors must report rate information under HMDA (currently 3 percent for first-lien loans and 5 percent for subordinate-lien loans) to conform to new definition of "higher-priced" mortgages under the amended Regulation Z.
4 12 CFR § 226.34(a); 12 CFR § 226.35(b)(1).
5 12 CFR § 226.34(a)(4).
6 12 CFR § 226.32(d)(6)-(7); 12 CFR § 226.35(b)(2).
7 12 CFR § 226.32(d)(6)-(7); 12 CFR § 226.35(b)(2).
8 12 CFR § 226.35(b)(3).
9 12 CFR § 226.36(b)(1).
10 12 CFR § 226.36(b)(2).
11 12 CFR § 226.36(c)(i).
12 12 CFR § 226.36(c)(ii).
13 12 CFR § 226.36(c)(iii).
14 Comment 226.16-2.
15 12 CFR § 226.24(i).
16 12 CFR § 226.19(a)(1).

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Thomas J. Cunningham, P. Russell Perdew, J. Matthew Goodin and Bryan W. Deaton represent banks, mortgage lenders, insurance companies and other financial institutions, as well as many other types of business clients, in state and federal courts throughout the country. They concentrate their practice in defending class-action litigation.