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Real Estate

Predatory Lending Legislation Cuts Wide Swath

If you are an attorney or title agent and you simply follow a lender's closing instructions, you might be a predator

By Alfred D. Santoro Jr.

Proposed federal and state legislation substantially expands the liability of those participating or facilitating refinance transactions, including attorneys and title insurance agents.

You are handling a simple refinance transaction for a new client. The client has already received his mortgage commitment and has agreed to the terms of the loan. You, as the closing attorney, receive closing instructions from the lender, including amounts for lender fees to show on your closing statement.

In accordance with those instructions, you obtain title insurance for the lender, together with a closing service letter from the title insurance company authorizing you to close the loan. You proceed to close the loan in accordance with your instructions, record documents and collect your fee. You're done right?

Wrong, as you find out when you are notified of a civil suit alleging your participation in predatory lending practices!

Of course, you are not alone; along with the mortgage lender/ mortgage broker, the title insurance company is being sued because they have allegedly facilitated the fraud by the issuance of the Closing Service Letter authorizing you to close the loan.

Refis on the Rise

In a recent case, an individual who had been refinanced three times within two years sued her mortgage lender, attorney and title company, alleging that the repeated refinancing forced her into foreclosure.

Situations like these have already occurred in New Jersey, and soon, federal and state regulatory bodies may have additional powers to bring such charges themselves.

According to a Joint HUD-Treasury Task Force report, more than 70.7 million American families owned their own home in the first quarter of 2002. Throughout the past year, record numbers of those families have been refinancing their homes to take advantage of lower interest rates and consolidate debt.

All too often however, low- and moderate-income families have fallen prey to a variety of predatory lending practices that, alone or in combination with loan terms, are abusive and make a borrower more vulnerable to abusive practices.

Most of these abuses occur in the subprime lending market. While subprime lending does serve a valuable purpose in providing loans to borrowers who do not meet credit standards for the prime mortgage market, the report indicates the subprime borrowers are particularly susceptible to abusive lending practices.

One difficulty in regulating predatory lending has been the difficulty in defining it. According to the report, "Predatory Lending … involves engaging in deception or fraud, manipulating the borrower through aggressive sale tactics, or taking unfair advantage of a borrower's lack of understanding of loan terms."

Generally, predatory lending falls into four categories.

Loan Flipping: Refinancing borrowers repeatedly in a short time period, building in additional fees and prepayment penalties that work to reduce home equity.

Excessive Fees and Packing: Fees that far exceed those justified on economic grounds and the practice of "packing" those fees into the loan amount without the borrower's complete understanding.

Lending Without Regard to the Ability To Repay: Lending based solely on equity. In cases involving elderly borrowers on fixed incomes, this practice leads quickly to default and foreclosure.

Outright Fraud and Abuse: Deceptive or high-pressure tactics focused primarily on the elderly, lower income and less educated borrower.

The report further states that preda-

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tory lending practices are not limited to loan origination but "can occur at any stage of the loan process and be undertaken, or at least facilitated by any of the many participants in a particular transaction."

Although the ability of the federal and state authorities to police and prosecute these violations is somewhat limited, more resources are being devoted to doing so. Recently, First Alliance Mortgage Corporation made the largest settlement ever in a predatory lending case with the Federal Trade Commission. First Alliance will repay some $60 million dollars to more than 18,000 borrowers.

The practices complained of included charging very high fees for loans (up to 25 points in some cases); offering adjustable rate mortgage loans that adjust upward automatically without regard for the economy or a separate index; and failing to disclose these practices to borrowers.

HOEPA Amendments

The Home Ownership and Equity Protection Act was enacted in 1994 and addresses abusive lending practices in the home-equity lending markets. The board of governors of the Federal Reserve System has recently adopted changes to Regulation Z (Truth in Lending), which implements HOEPA. These amendments are contained in 12 C.F.R. 226.

Prior to the amendments, a home-equity loan was covered by HOEPA if (1) the annual percentage rate exceeds the rate for Treasury securities with a comparable maturity by more than 10 percentage points or (2) the points and fees paid by the consumer exceed the greater of 8 percent or $400 ($465 in 2001 and $480 in 2002).

Under the amendment, the APR trigger is reduced to 8 points for first lien loans and the fee-based trigger now includes amounts paid at closing for optional credit life, accident health or loss of income insurance and other debt-protection products.

Another provision of the amendment seeks to end abusive "flipping" practices by prohibiting a lender from "[W]ithin one year of having extended credit subject to HOEPA refinance any such loan to the same borrower into another loan governed by HOEPA unless the refinancing is in the borrower's best interest."

This provision creates a presumption of predatory lending on a refinancing conducted within one year of an original refinance. The borrower's best interest is to be determined by the "totality of the circumstances." The board of governors viewed this restriction as being necessarily narrow stating that it viewed the likelihood of a legitimate lender refinancing one of its own HOEPA loans within one year as relatively low.

Record numbers of families are refinancing to take advantage of lower interest rates, with many falling prey to a variety of abusive lending practices.

Last, the amendment prohibits a lender from engaging in a pattern or practice of making HOEPA loans based on the equity in a borrower's home without regard for the consumer's ability to repay. All these amendments have been adopted and become mandatory Oct. 1, 2002.

New Federal Legislation

Senator Paul Sarbanes (D-Md.) has introduced the "Predatory Lending Consumer protection Act of 2002" (*S-2415*). This legislation would further amend HOEPA by again lowering the percentage-based triggers to 6 percent for first mortgages, 8 percent for second mortgages and fee-based triggers to mortgages where total points and fees exceed the greater of 5 percent of the total loan or $1,000.

The bill also prohibits prepayment penalties after the initial 24-month period of the loan and limits those that can be charged during the first 24 months. Right now there is no federal limit on prepayment penalties within the first five years.

Other provisions of the bill seek to prohibit balloon payments, upfront payments and financing of credit insurance and mandatory arbitration clauses. Additional disclosures as to the risks of high-cost loans and further prohibitions on asset-based lending without regard for the ability to repay are also proposed.

The bill also increases statutory damages for violations to $10,000 for individuals and, in class actions, to the greatest of $10,000 times the number of class members or 2 percent of the company's net worth.

New Jersey Follows Suit

The New Jersey Home Ownership Security Act of 2002, *A-75*, has been introduced by Assemblyman Matthew Ahearn (D-Bergen) and others. (An identical bill has been introduced in the Senate as *S-1540*.) The bill, now renamed the New Jersey High Cost Home Loan Protection Act of 2002, applies to home loans in New Jersey not exceeding $300,000, where points and fees total 6 percent of the loan amount or more.

Among its many provisions, the bill as amended through June 6, includes an effective prohibition of refinancing with the same lender within 12 months by prohibiting the charging of points in connection with such a loan. It also limits late fees and prohibits charging fees for obtaining payoff statements and discharging mortgages.

A-75 prohibits balloon payments within 180 months of the loan origination and, similar to the proposed federal legislation, prohibits mandatory arbitration clauses. It also requires extensive notification of the availability of loan counseling.

Proposed amendments to *A-75* pro-

vide for penalties to be assessed against "Any person found by a preponderance of the evidence to have violated this act." These penalties include statutory damages in the amount equal to finance charges plus 10 percent of the loan amount, punitive damages, costs, attorneys' fees and voiding of the loan.

In addition, "Any person, including members, officers and directors of the creditor who knowingly violates this act is guilty of a disorderly persons offense and is subject to a fine not exceeding $1,000 or to imprisonment of up to six months or both."

Lender Opposition

The New Jersey Mortgage Banker's Association has adopted a position opposing the proposed state legislation and, in fact, challenges even the need for the legislation.

In a memo dated May 28, 2002, the association states, "There have been isolated instances of predatory lending in New Jersey but they have never risen to the level of a widespread problem or practice in the State."

Among their concerns is the vague and subjective test of what constitutes a "Net Tangible Benefit" to a borrower. They contend that this test would serve to make it practically impossible to refinance a borrower in need. They also believe that the thresholds that trigger the applicability of *A-75* are erroneous as they include loans where 5 percent in points and fees are charged (since the original bill included yield spread premiums, prepayment penalties and even some third-party fees within that 5 percent).

Some of these concerns are valid. Vague and subjective tests used to determine whether a violation of law exists are inherently dangerous. However, yield spread premiums, as a target of predatory lending practices, should be examined more closely.

Originally designed to assist a borrower by providing upfront cash for loan costs in return for a higher interest rate, they have evolved into a method for compensating mortgage brokers and, in some cases, for steering borrowers into a higher interest rate than necessary.

Since yield spread premiums are essentially the borrower's money, and are incorporated into the APR, including them within the trigger appears to make sense.

The bill does include third-party fees within the trigger, if those fees are paid to affiliated businesses. Today, it is common for lenders to have affiliations with appraisers, tax service companies and even title companies.

Federal law permits those affiliations so long as they are disclosed to a borrower. It is not inconsistent to require that fees earned by a lender in these ventures be included because they represent a legitimate cost of the loan paid to a lender or affiliate.

Expanded Liability

Where the existence of a violation hinges on whether or not the lender has adequately researched if the borrower can repay a loan, or if a determination has been made that the loan is in the best interest of (or provides a net tangible benefit to) the borrower, too much responsibility is laid at the door of attorneys and the title industry. These professionals are not police. There are limits to their investigative authority and responsibility.

Attorneys and title insurance agents are required to comply with a lender's instructions. If those instructions violate the myriad of existing or new legislation, will those professionals be held as accountable as the creditor?

It is entirely possible that a violation of the prohibitions against coercive sales tactics may have taken place without the knowledge of the closing agent and well prior to his or her involvement. Yet, the new legislation tends to paint everyone with a broad brush, regardless of actual culpability.

The proposed regulations are addressing serious problems in the home-lending market. In order to be effective, they must be tied to some absolutes, including prohibitions on certain practices that, although beneficial to consumers, are open to enormous potential for abuse.

Today's real estate closings are already too full of disclosures and disclaimers to allow the consumer to independently assess the risks and benefits of a particular loan. Clear legislation that allows all parties to a transaction to readily identify prohibited activities is required to protect the consumer and the real-estate professional as well as to allow continued access to credit on a fair basis. ■