The Federal Reserve's Proposed Amendments To Regulation Z Threaten To Increase Consumer Litigation Against The Mortgage Industry

On December 18, 2007, the Federal Reserve proposed important new amendments to Regulation Z, which implements the Truth in Lending Act ("TILA") and Home Ownership and Equity Protection Act ("HOEPA").[1] The proposal would markedly increase regulation of a broad array of mortgage lending practices, including mortgage loan advertising, consumer disclosures, the assessment of borrowers' ability to repay, and products such as no-asset verification mortgages, and mortgages involving prepayment penalties. Although Federal Reserve Chairman Ben S. Bernanke has stated that the proposed amendments were designed "with an eye toward deterring improper lending and advertising practices without unduly restricting mortgage credit availability," the new regulations may both make it more difficult for qualified borrowers to obtain a mortgage, and expose mortgage lenders to significantly increased risks of litigation and potential liability.[2]

Increased Regulation of "Higher-Priced" And Traditional Mortgage Loans

The proposal establishes a new categorization of mortgage product called "higher-priced mortgages," which are subjected to a heightened degree of regulation. The proposal defines "higher-priced mortgage loans" to include "consumer-purpose, closed-end loans secured by a consumer's principal dwelling and having an annual percentage rate ("APR") that exceeds the yield on Treasury securities of comparable maturity by at least three percentage points for first-lien loans, or five percentage points for subordinate-lien loans." Although this definition would include the products most consider to be "subprime" loans, the definition is based broadly on the loan's

[1] The proposal can be located at: www.federalreserve.gov/newsevents/press/bcreg/bcreg20071218a1.pdf

[2] Statement of Ben S. Bernanke, Chairman of the Federal Reserve Board (Dec. 18, 2007).

interest rate, covering any mortgage loan with APRs 3% (or 5%) above comparable treasury securities, which would encompass many loan products not previously considered "subprime." Such "higher-priced mortgage loans" would be subjected the following additional regulations:

- Lenders would be prohibited from engaging in a "pattern or practice" of lending without considering the borrowers' ability to repay the loans from sources other than the home's value;
- Lenders would be prohibited from making loans relying on unverified income or assets;
- Lenders would be prohibited from imposing prepayment penalties without certain conditions, including the condition that the penalty expires at least sixty days before any possible payment increase;
- Lenders would have to establish an escrow account for property taxes and homeowners' insurance, and may only offer the borrower the opportunity to opt out of the escrow account after one year.

In addition, the proposal "would prohibit creditors from structuring closed-end mortgage loans as open-end lines of credit for the purpose of evading these rules."

The proposal also changes regulation of traditional mortgages in a manner that threatens to increase litigation. For example, the proposal addresses the relationships between and among lenders, brokers and appraisers, prohibiting lenders and brokers from coercing or encouraging an appraiser to misrepresent the value of a home, which threatens to impose liability on lenders for improper or incorrect actions by appraisers. In addition, common servicing practices, such as crediting payments on the date or receipt, providing loan payoff statements upon request and delivering fee schedules to consumers, would have to be completed in a reasonable time or on a "timely basis," which threatens to increase consumer litigation against servicers.

Regulations Over Mortgage Advertising

The proposal also would regulate mortgage advertising for closed-end mortgage loans, and would prohibit the following practices:

- Advertising fixed rates or payments for variable loans;

- Comparing rates and payments of products without disclosing the rates or payments that will apply over the loan’s full term;
- Mischaracterizing private mortgage products as being supported by the government;
- Allowing third parties to use the mortgage lender’s name without also prominently disclosing that the advertisement is from a third party unaffiliated with the mortgage lender;
- Advertising debt elimination claims when the product would merely replace one debt obligation with another;
- Advertising that creates a false impression that the lender or broker has a fiduciary relationship with the consumer;
- Advertising certain information in a foreign language while required disclosures are provided only in English.

The Proposal Could Lead To Significant Damages And Additional Litigation

The proposal affords a private right of action for consumers to sue lenders for violations, as well as the right to rescind certain mortgages containing a prohibited provision. In civil actions, consumers could recover: (i) actual damages; (ii) statutory damages in an individual action of up to $2,000 or, in a class action, total statutory damages for the class of up to $500,000 or one percent of the creditor’s net worth, whichever is less; (iii) special statutory damages equal to the sum of all finance charges and fees paid by the consumer; and (iv) court costs and attorneys’ fees. Violations of the advertising rules, however, would expose the creditor to administrative enforcement only.

Whether the Federal Reserve’s proposed regulations will lead to additional litigation is unclear, as the proposal remains subject to public comment and may possibly be amended. Moreover, Senator Christopher Dodd, Chairman of the Senate Banking Committee, and Representative Barney Frank, Chairman of the House Committee on Financial Services Democratic leaders have indicated that they plan to proceed with their own more aggressive proposed legislation to regulate the mortgage industry.[3]

[3] *See* Damian Paletta and James R. Hagerty, Fed's New Rules on Mortgages Draw Hostility, The Wall Street Journal, Dec. 19, 2007.