HOME OWNERSHIP EQUITY PROTECTION ACT OF 1994

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Recent Congressional attention to the problems of predatory mortgage lending has led for calls for the Federal Reserve Board to use its authority under the Home Ownership and Equity Protection Act of 1994 ("HOPEA" or the "Act")[2] to provide addition protection for consumers with respect to mortgage loans. This article will review the legislative history and provisions of HOPEA, and explain the scope of the authority of the Federal Reserve Board (the "Federal Reserve" or the "Board") under that statute.

Legislative History and Statutory Provisions

HOEPA was enacted in 1994 in response to Congressional concerns over "reverse redlining." According to the Senate Banking Committee report accompanying the legislation, "reverse redlining" is the practice of targeting residents of specific disadvantaged communities for credit on unfair terms, and in particular by second mortgage lenders, home improvement contractors, and finance companies.[3] These lenders were felt to "peddle high-rate, high-fee home equity loans to cash-poor homeowners."[4] According to the legislative history, the law is not designed to cover purchase money mortgages, but only first and second closed-end loans[5] with high fees and costs, that are used to "skim" the built up equity in the homes of vulnerable consumers.[6] The legislation was also intended to only target the abusive loans, "without materially restricting the flow of credit or imposing an excessive burden on lenders or consumers."[7]

To achieve these goals, HOPEA establishes a class of residential mortgage loans (for purposes of this article only, these loans will be referred to as "high cost") that are subject to special disclosures and other requirements. A high cost loan is defined as a closed-end, non-purchase mortgage loan, secured by a consumer's principal residence, that has an annual percentage rate in excess of 10 percent above Treasury securities with a comparable maturity, or that has total fees and points that exceed the greater of $400 or 8 percent of the total loan

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[2] Title I, Subtitle B of the Riegle Community Development and Regulatory Improvement Act of 1994, Public Law 103-325 §§ 151-158 (1994).

[3] S. Rep. No. 103-169 at 21.

[4] Id.

[5] A closed-end loan is a loan for a specific amount of money to be repaid over a fixed term. An "open-end" loan is a loan in which the borrower has the right to take additional advances during the loan term, and the line of credit varies depending upon the outstanding balance.

[6] Id. at 22.

[7] Id. at 23.

amount. The Federal Reserve is given authority to adjust these triggers, within certain parameters. As adjusted by the Board, the current triggers are 8 percent above Treasuries for a first loan, and 10 percent above Treasuries for a second loan, and the fee trigger has been raised to the greater of 8 percent of the loan or $547 to reflect inflation.[8]

High cost mortgages are subject to additional disclosure requirements, which must be made at least 3 days prior to the loan closing. The Act imposes substantive restrictions on these loans, including prohibitions on prepayment penalties (unless certain conditions are met),[9] penalty interest rates in the event of a default, balloon payments for short-term loans, and negative amortization features. A creditor may not engage in a "pattern or practice" of extending credit through high cost mortgages without regard to the consumers' repayment ability, including current and expected income, obligations, and employment.

Under the Act, a purchaser or assignee of a high cost mortgage is subject to all claims and defenses that could have been raised against the maker of the loan, unless the assignee demonstrates that a reasonable person, exercising ordinary due diligence, could not determine based on the documents and other disclosures that the mortgage was a "high cost mortgage."

The Fed's Regulatory Authority

The Federal Reserve is given the authority to issue implementing regulations, including the authority to modify the definition of a "high cost mortgage" by adjusting the triggers. Specifically, the Act permits the Board to set the APR trigger at any amount between 8 percent and 12 percent above Treasury securities with comparable maturities. The Board is also required to adjust the $400 fee trigger to reflect changes in the consumer price index.

The Board may, by regulation or order, exempt specific mortgages or categories of mortgages from any or all of the HOEPA requirements, or prohibit additional acts or practices in connection with any mortgage (not just "high cost mortgages") that the Board determines are unfair, deceptive, or designed to evade HOEPA, or that are made in connection with a re-financing of a mortgage loan that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.[10] Finally, the Board is given the general regulatory power to issue "such regulations as may be necessary" to carry out HOEPA.

The Board initially issued implementing regulations in 1995.[11] In 2001, the Board amended these regulations to broaden the coverage of the Act and to prohibit certain practices

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[8] 12 C.F.R. § 226.32 and Supplement I.

[9] The loan may include a prepayment penalty if certain conditions are met and if the penalty does not apply 5 years after the date of the loan origination.

[10] 12 U.S.C. § 1639(*l*).

[11] 60 Fed. Reg. 15463 (1995); 12 C.F.R. §§ 226.32 and 226.34.

that the Board determined where unfair, deceptive, or designed to evade HOEPA.[12] The 2001 amendment extended the scope of coverage of HOEPA by lowering the trigger for first mortgage loans from 10 percent above comparable Treasuries to 8 percent. The fee-based trigger was adjusted in 2001 by including optional credit insurance and other debt protection products written in connection with the extension of credit.

Potential Board Actions

- The Board could further reduce the percentage trigger, so that a first or second loan that has an APR of 8 percent or more above comparable Treasuries is covered.
- The Board could further revise the definition of "fee" to encompass a broader range of charges that are not included in the finance charge under the Truth-in-Lending Act.
- The Board could modify required disclosures for high cost mortgages.
- The Board could widen the presumption that a lender is making high cost loans without regard to the borrower's repayment ability.
- The Board could proscribe additional practices or mortgage terms for any mortgage deemed as being unfair, deceptive, or designed to evade HOEPA, or with respect to the refinancing of any mortgage loans that the Board determines are abusive or not in the best interests of the borrower.

Regulatory Authority With Respect to Non-HOEPA Loans

While HOEPA is primarily concerned with high cost loans, it also provides the Board with the authority to proscribe certain practices with regard to all mortgage loans. In particular, the statute states:[13]

> The Board, by regulation or order, shall prohibit acts or practices in connection with –
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> > (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
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> > (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.

[12] 66 Fed. Reg. 665617 (2001).

[13] 15 U.S.C. § 1639(*l*) (2).

Unlike the definition of high cost mortgage, which is limited to non-purchase money, closed-end loans, this section of HOEPA refers to "mortgages" generally. Thus, based on the literal language, it appears to encompass all types of mortgages, and not just those that meet the definition of a high cost mortgage. Indeed, logic also dictates this interpretation, since one of the purposes of this section is to enable the Board to regulate mortgages that are "designed to evade" the provisions of the HOEPA law, presumably by not meeting the definition of a high cost loan.

The term "mortgage" is not defined in HOEPA or in the Truth-in-Lending Act, which is amended by HOEPA.[14] Under traditional principles of statutory construction the word's usual and customary meaning should be used. The usual meaning of the term "mortgage" is a lien secured by real property, and the term does not differentiate between closed-end or open-end loans.[15] However, it could also be argued that the legislative history of HOEPA indicates the law was not designed to cover purchase money mortgages, but only first and second closed-end loans with high fees and costs, that are used to "skim" the built up equity in the homes of vulnerable consumers.[16] In either case, the term "mortgage" would appear to cover a first or second closed-end loan secured by real estate. It may be argued that it should not be interpreted to cover purchase money loans and lines of credit. However, in light of the use of term "mortgage" without qualification in the statute, the Federal Reserve would have ample authority to encompass all types of mortgage loans within the scope of any regulation it promulgates.

With respect to the substance of any regulatory action, it is clear that HOEPA gives the Board the power to regulate any act or practice that the Board determines is "unfair, deceptive, or designed to evade the provisions of [HOEPA]." This appears to provide ample authority, for example, for the Board to prohibit the practice of extending mortgage credit (or a category of mortgage credit) that does not take into consideration the ability of the borrower to repay the loan at a fully indexed rate. Similarly, Board regulations could provide that certain types of mortgage loans cannot have a negative amortization feature, or that certain additional disclosures must be made. In fact, all of the requirements in the existing and proposed regulatory guidance could be applied to all mortgage lenders through this section of HOEPA.

With respect to re-financing transactions, the Board's authority includes the ability to prohibit any act or practice that it determines is "abusive" or that is "otherwise not in the interest of the borrower." This authority could justify the Board taking any number of actions, including all of those in the recently promulgated and proposed guidance. The Board could also require that for certain borrowers the lender would have to document that a refinancing transaction is in the "best interest of the borrower."

<u>Assignee Liability</u>

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[14] The Truth-in-Lending Act refers to "residential mortgage transaction," defined as a "transaction in which a mortgage ... is created or retained against the consumer's dwelling to finance the acquisition or initial construction of such dwelling." 15 U.S.C. § 1602(w).

[15] Black's Law Dictionary, Sixth Ed. (1991).

[16] <u>S. Rep. No</u>. 103-169 (1993).

Assignee liability only applies to mortgage loans that meet the definition of "high cost" loan. The Board's authority to modify the definition of a "high cost loan" is limited to: (i) adjusting the APR trigger (between 8 and 12 points above Treasuries); (ii) changing the definition of a "fee" to include additional charges; and (iii) adjusting the fee trigger to reflect inflation. If a loan meets one of the triggers, an assignee will have liability for the actions of the maker, unless the assignee can demonstrate that the reasonable person could not determine that the loan was a "high cost" loan based on a review of all of the loan documentation.

If a loan does not meet the APR or fee trigger, the HOEPA assignee liability provision does not apply.[17] So for example, if the Federal Reserve Board issued a regulation under HOEPA prohibiting prepayment penalties for all mortgage loans that have an APR that is 5 or more points above Treasuries, a loan that was made in violation of this regulation would not result in assignee liability unless the APR was 8 or more points above Treasuries (the HOEPA trigger).

<u>Private Actions and Class Actions</u>

A lender that violates any of the provisions in HOEPA, including the Board's implementing regulations, may be liable in a private action or class action. Thus, if the Board prohibits prepayment penalties for loans with an APR that is 5 points above Treasuries, a lender who makes such a loan in violation of the regulation will be subject to potential class action suits. The Truth-in-Lending Act provides a limit on class action recoveries.

<u>State Attorney General Actions</u>

A State Attorney General may also bring an action to enforce HOEPA or the Board's implementing regulation, after giving notice to the appropriate Federal agency, e.g. a Federal banking agency if the action is against an insured depository institution. The Federal agency may intervene in the proceeding and remove the case to Federal court.[18]

<u>Right of Rescission</u>

A high cost mortgage that contains a term prohibited by HOEPA or the Board's regulation is deemed to be a failure to deliver a material disclosure under the Truth-in-Lending Act. As a result, the borrower has a three year period to rescind the loan.

<u>Agency Enforcement</u>

Violations of HOEPA, including Federal Reserve regulations, are enforced against non-depository institutions by the Federal Trade Commission.[19] The Act and regulations are

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[17] Assignee liability could also be imposed by regulatory action, for example, if the Board requires certain loans to state on the face of the document that assignees are subject to all claims that could be made against the originating party. However, there is nothing in HOEPA that would mandate such action.

[18] 12 U.S.C. § 1640(e).

[19] 15 U.S.C. § 1607.

enforced against insured depository institutions by the appropriate Federal banking agency, e.g. the Comptroller of the Currency for national banks. As noted above, State Attorneys General may also enforce violations of HOEPA and the Board's implementing regulations.

Criminal Penalties

A person who willfully and knowingly fails to comply with HOEPA or the Board's regulation may be subject to a criminal fine or imprisonment.[20]

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[20] 12 U.S.C. § 1611.