



A Model State Statute

**FINANCIAL
PROTECTION**



**Home
Loan
Protection
Act**

HOME LOAN PROTECTION ACT

A MODEL STATE STATUTE

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The AARP Public Policy Institute, formed in 1985, is part of the Policy and Strategy Group at AARP. One of the missions of the Institute is to foster research and analysis on public policy issues of importance to mid-life and older Americans. This publication represents part of that effort. The views expressed herein are for information, debate, and discussion, and do not necessarily represent official policies of AARP.

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The subprime (that is, non-prime or below “A” rated credit) mortgage lending industry has grown significantly in recent years, expanding from a \$35 billion industry in 1994 into a \$140 billion industry in 2000. Subprime mortgages currently represent 13 percent of total mortgage originations, an increase from four percent of originations in 1994. A recent study found that older borrowers were three times more likely to hold a subprime mortgage than borrowers younger than 35 years of age.¹

A combination of factors account for the growth in the subprime mortgage lending industry. These factors include: increased home equity and homeownership, particularly in minority and low-income communities; federal preemption and deregulation of state usury ceilings; elimination of the consumer loan tax deduction; and increased availability of capital through securitization.

There is increasing concern about subprime lending for several reasons, including growing evidence of abusive lending practices in the subprime lending market. Practices such as charging exorbitant fees and interest rates often occur when subprime borrowers are unsure about their credit history and loan eligibility or are unaware of mortgage details (balloon payments and prepayment penalties, for example).

In a recent joint report on predatory mortgage lending, the United States Departments of Housing and Urban Development and Treasury cite four categories of “all too frequent abuses” in the subprime market:

- loan flipping²;
- excessive fees and “packing”³;
- lending without regard to the borrower’s ability to repay; and
- outright fraud and abuse.

Similarly, federal banking regulators⁴ have issued examination guidance for supervising subprime lending activities that targets the following potentially abusive lending practices: making unaffordable loans based on the assets of the borrower rather than on the borrower’s ability to repay an obligation; inducing a borrower to refinance a loan repeatedly to charge high points and fees each time the loan is refinanced; or engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

Abusive subprime lenders often target older homeowners, who frequently have substantial equity in their homes. Nearly 80 percent of older Americans are homeowners, and 80 percent of these older homeowners own their homes free and clear. According to the latest American Housing Survey (1999), over 60 percent of homeowners age 65 and older had at least \$50,000 in home equity. Moreover, older homeowners are more likely to live in homes in need of repair, and less likely than younger homeowners to do the home repair work themselves.

¹ Lax, H., et. al. *Subprime Lending: An Investigation of Economic Efficiency*. Unpublished paper (February 2000).

² “Flipping” a loan is making a home loan that refinances an existing home loan when the new loan does not have a tangible net benefit to the borrower. This practice results in high fees, including prepayment penalties, that strip the equity in the borrower’s home.

³ “Packing” refers to the addition of extra fees to the loan amount. These fees are generally unnecessary and expensive and often unknown to or unwanted by the borrower.

⁴ Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision.

A MODEL STATUTE

This model state statute, Home Loan Protection Act (HPLA), is designed to protect borrowers from abusive practices such as flipping and the inappropriate financing of points and fees. Under the Model Act, lenders making high-cost loans must consider the borrower's ability to repay and may not approve a loan based solely on the equity in the home.⁵

Homeownership by Americans reached a record 67.4 percent in 2000, and represents a key component of economic security, especially for minority families and families with lower incomes. Stripping equity wealth through high-cost, abusive loans threatens to reverse these gains and destabilize entire neighborhoods. The HPLA is intended to prevent such losses while maintaining homeowner's access to credit. Enacting its provisions will help to ensure that millions of older Americans will be able to remain financially secure in their homes and communities.

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⁵ The practice of making mortgage loans based solely on the value of the property or equity in the home is known as "asset-based lending."

**Section 1.
TITLE,
PURPOSES**

- (a) *This Act shall be known as the Home Loan Protection Act.*
- (b) *The General Assembly finds that abusive mortgage lending has become an increasing problem in this state, exacerbating the loss of equity in homes and causing the number of foreclosures to increase in recent years. One of the most common forms of abusive lending is the making of loans that are equity-based, rather than income-based. The financing of points and fees in these loans provides immediate income to the originator and encourages lenders to repeatedly refinance home loans. The lender's ability to sell loans reduces the incentive to ensure that the homeowner can afford the payments of the loan. As long as there is sufficient equity in the home, an abusive lender benefits even if the borrower is unable to make the payments and is forced to refinance. The financing of high points and fees causes the loss of precious equity in each refinancing and often leads to foreclosure.*

Abusive lending has threatened the viability of many communities and caused decreases in homeownership. While the marketplace appears to operate effectively for conventional mortgages, too many homeowners find themselves victims of overreaching lenders who provide loans with unnecessarily high costs and terms that are unnecessary to secure repayment of the loan. The General Assembly finds that as competition and self-regulation have not eliminated the abusive terms from home-secured loans, the consumer protection provisions of this Act are necessary to encourage lending at reasonable rates with reasonable terms.

- (c) *This Act shall be liberally construed to effectuate its purpose of protecting the homes and the equity of individual borrowers. This Act is to be construed as a consumer protection statute for all purposes.*

Section 1 establishes the framework for the substantive provisions of the Model Act. The purpose of the Model Act is to protect the homes and equity of individual borrowers. As it is a consumer protection law, it should be construed liberally. The Model Act is based on the principles that:

- (1) some lending practices are so inherently abusive that they should be flatly prohibited in all home loans; and
- (2) home-secured loans that have high fees or high interest rates have greater potential to be harmful to consumers; therefore, these loans should be subject to additional restrictions to ensure that consumers are protected.

Instead of setting ceilings on fees and interest rates, the Model Act prohibits certain loan terms and lending practices for high-cost loans. This approach follows the structure used in the federal Home Ownership and Equity Protection Act (HOEPA). HOEPA similarly creates special requirements applicable to high-cost loans. However, the HOEPA thresholds for high-cost loans are too high to reach the bulk of high-cost loans. According to data cited by the Federal Reserve Board, only one percent of such loans is currently covered. In addition, HOEPA does not prohibit or substantially restrict these high-cost loans; HOEPA relies instead on additional disclosures to protect consumers. Unlike HOEPA, which was designed to protect existing homeowners, the Model Act covers both refinance and home purchase loans.

MODEL
STATUTE

**Commentary:
Title,
Purposes**

**Section 2.
DEFINITIONS**

Like HOEPA, the Model Act sets triggers for high-cost loans. The interest rate trigger for high-cost loans is the yield on five year United States Treasury securities plus six (6) points and the points and fees trigger is three percent (3%) of the loan amount. These provisions will not unduly affect legitimate subprime mortgage credit. Legitimate subprime mortgage loans have terms and features nearly identical to those included in conventional home loans. Generally, only the interest rates of legitimate subprime mortgage loans differ and are slightly higher than those in the conventional market.

The following definitions apply for the purposes of this Chapter:

- (a) *“**Benchmark Rate**” is the interest rate which the borrower can reduce by paying bona fide discount points; this rate shall not exceed the weekly average yield of United States Treasury securities having a maturity of five (5) years, on the fifteenth (15th) day of the month immediately preceding the month in which the loan is made, plus four (4) percentage points.*
- (b) *“**Bona Fide Discount Points**” means loan discount points which are:*
 - (1) *Knowingly paid by the borrower;*
 - (2) *Paid for the express purpose of lowering the benchmark rate;*
 - (3) *In fact reducing the interest rate or time-price differential applicable to the loan from an interest rate which does not exceed the benchmark rate; and*
 - (4) *Recouped within the first four (4) years of the scheduled loan payments.*

For purposes of assessing compliance with Subparagraph (b)(4), loan discount points will be considered to be recouped within the first four (4) years of the scheduled loan payments if the reduction in the interest rate that is achieved by the payment of the loan discount points reduces the interest charged on the scheduled payments such that the borrower’s dollar amount of savings in interest over the first four (4) years is equal to or exceeds the dollar amount of loan discount points paid by the borrower.

- (c) *“**Borrower**” means any natural person obligated to repay the loan, including a coborrower, cosigner, or guarantor.*
- (d) *“**Creditor**” means a person who extends consumer credit that is subject to a finance charge or is payable by written agreement in more than four (4) installments, and to whom the obligation is payable at any time.*
- (e) *“**High-Cost Home Loan**” means a home loan in which the terms of the loan meet or exceed one (1) or more of the thresholds as defined in Subsection (i) of this section.*
- (f) *“**Home Loan**” means a loan, including an open-end credit plan, other than a reverse mortgage transaction, where the loan is secured by:*
 - (1) *A mortgage or deed of trust on real estate in this state upon which there is located or there is to be located a structure or structures designed principally for occupancy of from one to four (1-4) families which is or will be occupied by a borrower as the borrower’s principal dwelling, or*
 - (2) *A security interest on a manufactured home which is or will be occupied by a borrower as the borrower’s principal dwelling.*

- (g) **“Points and Fees”** means:
- (1) All items listed in 15 U.S.C. §1605(a)(1) through (4), except interest or the time-price differential;
 - (2) All charges listed in 15 U.S.C. §1605(e);
 - (3) All compensation paid directly or indirectly to a mortgage broker, including a broker that originates a loan in its own name in a table-funded transaction;
 - (4) The cost of all premiums financed by the creditor, directly or indirectly for any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the creditor directly or indirectly for any debt cancellation or suspension agreement or contract, except insurance premiums calculated and paid on a monthly basis shall not be considered financed by the creditor;
 - (5) The maximum prepayment fees and penalties that may be charged or collected under the terms of the loan documents; and
 - (6) All prepayment fees or penalties that are charged the borrower if the loan refinances a previous loan made by the same creditor or an affiliate of the creditor.
 - (7) For open-end loans, the points and fees are calculated by adding the total fees charged at closing plus the maximum additional fees which can be charged pursuant to the loan documents during the term of the loan.
- (h) **“Rate”** means the interest rate charged on the home loan, based on an annual simple interest yield.
- (i) **“Threshold”** means any one of the following three (3) items, as defined:
- (1) **Rate Threshold** means:
 - (A) For a first lien mortgage loan, the trigger rate equals or exceeds six (6) percentage points over the weekly average yield on five year United States Treasury securities;
 - (B) For a subordinate mortgage lien or a mortgage secured solely by a security interest in a manufactured home, the trigger rate equals or exceeds eight (8) percentage points over the weekly average yield on five year United States Treasury securities;
 - (C) The trigger rate is calculated as follows:
 - (i) For fixed-rate loans in which the interest rate will not vary during the term of the loan, the trigger rate is the rate as of the date of closing;
 - (ii) For loans in which the interest varies according to an index, the trigger rate is the sum of the index rate as of the date of loan closing plus the maximum margin permitted at any time under the loan agreement;
 - (iii) For all other loans in which the rate may vary at any time during the term of the loan, the trigger rate is the maximum rate that may be charged during the term of the loan.
 - (2) **Total Points and Fees Threshold** means the following, excluding up to two (2) bona fide discount points:
 - (A) For loans in which the total loan amount is \$30,000 or more, the total points and fees on the loan, paid by the borrower at or before closing, exceed three percent (3%) of the total loan amount;
 - (B) For loans in which the total loan amount is less than \$30,000, the total points and fees on the loan, paid by the borrower at or before

closing, exceed the lesser of \$900 or six percent (6%) of the total loan amount; [and]

OPTION

(3) Prepayment Penalty Threshold means the home loan agreement permits the lender to charge or collect payment penalties or penalties more than 30 months after the loan closing or which exceed, in the aggregate, more than two percent (2%) of the amount prepaid.

(j) “Total Loan Amount” means the principal of the loan minus those points and fees as defined in Subsection (g) of this section that are included in the principal amount of the loan. For open-end loans, the total loan amount shall be calculated using the total line of credit allowed under the home loan.

**Commentary:
Definitions**

The Model Act terms are defined in Section 2. While a number of the terms defined are adopted from the federal Truth in Lending Act (TILA), other terms are created for this Model Act.

- (a) **Benchmark Rate** is a new term created by the Model Act. It is used solely to determine whether a lender’s “discount points” are, in fact, reductions of the interest rate from a reasonable standard. For purposes of this Model Act, the “benchmark rate” is the yield on five year United States Treasury securities as of the 15th day of the month immediately preceding the loan closing plus four percentage points (400 basis points).*
- (b) **Bona Fide Discount Points** are additional points a lender may charge for reducing the interest rate on the loan. If the points meet the requirements established in the Model Act for “bona fide discount points,” these points are excluded from the calculation of points and fees that determine whether the loan is a high-cost loan and is subject to special protection under the Model Act. The two standards for “bona fide discount points” are: (1) the rate which the lender says is being reduced by the payment of points must be no higher than the “benchmark rate” as defined by the Model Act; and (2) the points paid must reduce the interest rate of the loan sufficiently so that the additional cost of the points will be recouped within four years or 48 months. Both of these standards must be met for the points to be considered “bona fide discount points.”

An example illustrates how to assess whether additional points are bona fide discount points under the Model Act. Where the interest rate on a loan of \$100,000 is nine percent for a term of 30 years, the borrower is offered a rate reduction to 8.5 percent with the payment of three points, or \$3,000. First, check the “benchmark rate” to ensure the rate being reduced is allowable.** To calculate the pay-back period, compare the monthly payments under each rate: \$804.62 per month at nine percent and \$768.91 per month at 8.5 percent. The difference between the payments (or the savings each month at the lower rate) is \$35.71. At that rate, it would take 84 months, or seven years, to recoup the \$3,000 paid in points. Thus, in this example, the points would not qualify as bona fide discount points because the additional cost of the points is not recouped within four years or 48 months.

* Treasury rates are published at <<http://www.federalreserve.gov/releases/h15/current/>> .

** The “benchmark rate” allowable under the Model Act is only 8.57 percent (4.57% + 4.0%) at the time of this publication.

New York and Massachusetts regulations define “bona fide discount point” as a rate reduction of 3/8 percent or 35 basis points for each discount point paid up front. This equals a 40-month recapture period—more restrictive than the Model Act.

- (c) **Borrower** is defined as any natural person obligated to repay the loan. In addition, coborrowers, cosigners, and guarantors are included in the definition of borrowers and have the same rights. This definition is broader than TILA’s which limits “borrowers” to those for whom a loan is made for personal, family, or household purposes. The Model Act’s definition includes all natural persons who are borrowing money secured by a home, regardless of how the borrowed funds are intended to be used. In addition, the Model Act covers any loan made for business purposes that is secured by a home.
- (d) **Creditor** is defined as covering all lenders who extend consumer finance credit that is subject to a finance charge or is payable by written agreement in more than four installments. This definition is broader than “creditor” under TILA, which limits creditors to persons who “regularly” extend credit, subject to a numerical standard. Creditors under this Model Act who make a single extension of credit secured by the home are covered.
- (e) **High-Cost Home Loan** is a loan which exceeds one of the thresholds defined in Subsection (i) of this section. These loans are subject to additional restrictions under the Model Act.
- (f) **Home Loan** includes all loans secured by the borrower’s home (home equity *and* home purchase loans), other than reverse mortgage transactions. The definition is intentionally broad and intended to include all home loans, including loans for business purposes if the home is taken as security.

Unlike HOEPA, the Model Act’s definition of a home loan includes both open-end *and* closed-end loans. The exclusion of open-end loans from HOEPA has facilitated the avoidance of the HOEPA protections by allowing abusive lenders to characterize their loans as open-end loans.

- (g) **Points and Fees.** The definition of points and fees builds on the points and fees trigger in HOEPA. Points and fees under the Model Act are defined broadly to include *all* loan charges, other than the note interest and the time-price differential. Under HOEPA, a number of important and expensive loan fees are omitted from the definition of points and fees, resulting in the exclusion of some very high-cost loans from HOEPA protections. For example, fees for title examination or document preparation are excluded from the points and fees trigger under HOEPA, as long as the fees are reasonable and are paid to an unaffiliated third-party. Only when all fees required to be paid to obtain the loan are included, however, can the actual cost of the loan be determined. In the Model Act, all fees charged to close the loan are included, regardless of whether they are paid to a third party. This provision is important because it is usually difficult to determine if the third-party is an affiliate, and the cost of these fees is often very high and a significant cause of equity stripping. Also, by including third-party fees in the definition of points and fees, the lender has a significant incentive to keep the costs of these fees low.

The Model Act specifically includes in the definition of points and fees all compensation paid *directly or indirectly* to a broker. Brokers are frequently involved in abusive loans and often receive indirect fees paid by the lender (also known as yield spread premiums [YSPs]) for placing borrowers in loans that have higher interest rates than warranted by the borrower's risk profile. Broker compensation, whether in the form of fees paid by the borrower or fees paid by the lender, directly affects how much the borrower pays for the loan, and, therefore, must be included in any meaningful assessment of a high-cost loan.

For example, a borrower goes to a broker to get a 30-year mortgage of \$100,000. Her credit scores, along with other indicators, would qualify her for a ten percent interest rate with most lenders and a monthly payment of \$877.57 (principal and interest). But the broker has an arrangement with "High Priced Loans, Inc.," where he receives four points (\$4,000) from the lender by getting a borrower to commit to an interest rate of 11 percent. The borrower, not knowing she qualifies for a better rate, enters into a loan that charges \$952.32 per month (principal and interest). The difference in finance charges over 30 years between these two loans is \$26,910.66.

The Points and Fees definition includes all financed credit insurance premiums and related products in recognition of their excessive cost and relative minimal value to consumers. This Model Act provision is consistent with changes proposed by the Federal Reserve to the HOEPA regulations.

Prepayment penalties are also included in the definition of points and fees whenever the penalty *can be charged* on the loan being made. This provision is important because it requires the lender to determine whether the initial cost of making the loan will be included in the payment of points and fees when the loan is made, or recouped on the back end if the loan is prepaid. There is little justification for double charging the borrower for the costs of making the loan—once by charging points and fees and again by charging prepayment penalties.

- (h) **Rate** means the interest rate charged on the home loan, based on an annual simple interest yield.
- (i) **Threshold** is a key provision of the Model Act because it determines which loans are subject to the restrictions on high-cost loans. Like HOEPA, the Model Act uses the alternative tests for either points and fees or interest rate [*or prepayment penalty, if included as a threshold—see Section 2 (i) 3*]. The Model Act's thresholds are lower than those in HOEPA, thus many more high-cost loans will be covered. The use of a "threshold" to define high-cost loans recognizes the same basic theory that underlies HOEPA: that additional regulation is warranted when the cost of a loan is substantially more than is charged in a typical market rate transaction. Exceeding any one of the two [or three] separate thresholds will cause a home loan to be treated as a high-cost loan, with the additional high-cost loan restrictions.

- (1) The **Rate Threshold** is a bifurcated threshold.

For a first lien mortgage loan, the threshold is met if the loan rate equals or exceeds by six percentage points (600 basis points) the yield on five-year United States Treasury securities as of the 15th day of the month immediately preceding the loan closing.

For a subordinate mortgage lien or a mortgage secured by a lien on a manufactured home, the rate threshold is met if the loan rate equals or exceeds by eight percentage points (800 basis points) the yield on five-year United States Treasury securities as of the 15th day of the month immediately preceding the loan closing.

The Model Act uses five-year United States Treasury securities as a benchmark. In contrast, HOEPA and new regulations in Illinois, Massachusetts, and New York use United States Treasury securities with terms comparable to the length of the loan as benchmarks. Such provisions complicate establishing rate thresholds and make lender compliance difficult. Using five-year United States Treasury securities more closely matches the actual expected life of mortgage loans, and particularly subprime loans. Due to prepayments, the average life of these loans is five years, even though the stated term may be 15, 20, or 30 years. Thus, using longer comparable term securities also overstates the actual United States Treasury securities rate because rates generally are higher on longer-term securities.

The purpose of using a bifurcated trigger—one for first liens and a higher trigger for second mortgage liens—is to encourage lenders to make second mortgages rather than refinancing a first mortgage with a small additional extension of credit to the consumer. This dual trigger system is also used in Illinois, Massachusetts, and New York. The higher trigger for second mortgages provides some incentive for lenders to make more second mortgages. When a homeowner needs to borrow only a small amount of the available home equity, current law encourages lenders to refinance existing (generally affordably priced) purchase money loans to provide a relatively small amount of additional credit.

In addition, most lenders prefer to be in first lien position because federal law preempts state law pertaining to interest rate and point caps. Having a lower trigger for first lien loans will encourage lenders to make second mortgages. The incentive of abusive lenders to refinance favorable lower rate first mortgage loans thus will be reduced. Second, these lenders will be subject to second mortgage loan laws in the states that have retained them.

- (2) The **Total Points and Fees Threshold** is different for loans equal to or exceeding \$30,000 and for loans of less than \$30,000. For loans equal to or exceeding \$30,000, the threshold is met if the total points and fees, excluding bona fide discount points (as defined in Section 2[b]), exceed three percent of the total loan amount. For loans less than \$30,000, the threshold is met if the total points and fees, excluding bona fide discount points (as defined in Section 2[b]), exceed the lesser of six percent of the total loan amount or \$900.

Total points and fees include all points and fees payable by the borrower at or before the loan closing (as defined in Section 2[g]). In the case of open-end loans, this includes any and all fees—as specified in the loan documents—which could be charged during the life of the loan on the total line of credit available.

- (3) **Prepayment Penalty Threshold:** *This is an optional provision that is strongly encouraged. However, it may be useful in certain states, but not in others.* The threshold is reached if the loan documents require the borrower to pay a penalty for prepaying the loan at any time after 30 months into the loan term, or if the penalty amount exceeds two percent of the outstanding loan balance.

As noted earlier, prepayment penalties are included in the points and fees, and they are a critical provision of the Model Act. Prepayment penalties, provisions which require significant sums for prepaying loans even years after consummation, have rapidly become one of the greatest home loan abuses. The Model Act addresses prepayment penalties by including them in the definition of points and fees and by applying special prepayment penalty protections for high-cost home loans [*and, if applicable, by having a separate prepayment penalty threshold*]. This focus on prepayment penalties is important for several reasons:

Prepayment Penalties Facilitate Yield Spread Premiums (YSPs) and Steering Borrowers to Higher Rate Loans. When a lender expends considerable expenses in making a loan, the lender risks loss if the loan is prepaid before the regular payments on the loan allow recoupment of these expenses. Market forces protect prime mortgage lenders because competition works to make the loans provided to prime borrowers at the lowest possible price, protecting the lenders of those loans against immediate refinancing. However, in the subprime mortgage market, brokers generally are the gatekeepers for the loans, and price competition is undermined by the widespread use of YSPs (an additional fee or bonus). A YSP is paid to a broker when the broker places a borrower in a loan with an interest rate higher than warranted by the borrower's risk profile. This premium can amount to several percent of the loan amount, or several thousand dollars. The larger the YSP a lender pays to a broker, the greater the likelihood that the borrower will be offered a loan with an interest rate substantially higher than necessary. The YSP paid to the broker is an expense that the lender must recoup to avoid a loss on the loan, especially considering that the same broker has an incentive to market another loan aggressively to the same borrower. Thus, the lender must charge prepayment penalties to protect itself from the costs incurred by YSPs. If prepayment penalties were disallowed for the high-cost loans, unreasonable YSPs would not be paid by lenders because they could not afford the risk. Reducing the incentive to charge YSPs would not limit access to legitimate mortgage loans; they are made every day in the prime market without exorbitant premiums and prepayment penalties.*

Prepayment Penalties Facilitate Equity Stripping. In addition to guaranteeing YSPs, prepayment penalties on high-cost loans strip borrower equity and lock borrowers into high-cost loans. A borrower refinancing a high-cost loan into a lower-cost loan loses equity because she must increase the loan amount on the new loan to cover the cost of the prepayment penalty. For example, a borrower with a \$100,000 loan and a five percent prepayment penalty pays the high-cost lender \$105,000 to pay off that loan, losing \$5,000 in equity. In addition, while the borrower

* It should be noted that Standard and Poor's has estimated that less than two percent of prime loans have prepayment penalties, while 50 percent to 80 percent of subprime loans have such penalties.

originally might have qualified for a lower-cost loan of \$100,000, she now finds that the prepayment penalty locks her into the current high-cost loan because she no longer qualifies (because of loan-to-value ratio) for the larger loan (\$105,000). Prepayment penalties also make it difficult for lenders to cross-market their lower-rate loans to borrowers who have improved their credit rating by paying their loans on time.

Requirements of the Model Act Do Not Prevent Recoupment of Reasonable Fees. As evidenced in the prime market, lenders are able to recoup the reasonable costs of making a loan without prepayment penalties. The Model Act permits fees of up to three percent of the total loan amount for loans of \$30,000 or more, and up to six percent for loans of less than \$30,000 (up to \$900) to be charged without subjecting the loan to additional restrictions. However, allowing these up-front fees in addition to prepayment penalties would permit the lender to charge twice for the same activity. Such actions are prohibited in the Model Act. Fees in the amounts permitted under the Model Act, by themselves, should be more than adequate to cover a legitimate lender’s costs for making the loan.

North Carolina, Illinois, and the District of Columbia limit prepayment penalties for some or all home loans. HOEPA contains and recent Massachusetts regulations contain a provision that only allows prepayment penalties when the loan is affordable to the borrower; however, this provision is seen as difficult to enforce. New York regulations address the issue by prohibiting the financing of prepayment fees on refinanced loans previously by the same lender. The Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) have recognized the problems with prepayment penalties, and they purchase only subprime loans with very limited prepayment penalty provisions.

- (j) **Total Loan Amount** is the principal of the loan, excluding all points and fees as defined in Subsection (g) that are included in the principal. This definition is the same as the HOEPA definition of total loan amount. Total loan amount differs from the principal amount of the loan, which includes up-front points and fees that are financed in the loan.

(a) ***Insurance and Debt Cancellation Agreements.*** No creditor making a home loan shall finance, directly or indirectly, any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract, except that insurance premiums or debt cancellation or suspension fees calculated and paid on a monthly basis shall not be considered financed by the creditor.

(b) ***Flipping.*** No creditor may engage in the unfair act or practice of “flipping” a home loan. “Flipping” a loan is the making of a home loan to a borrower that refinances an existing home loan when the new loan does not have reasonable, tangible net benefit to the borrower considering all of the

**Section 3.
PROHIBITED
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HOME LOANS**

circumstances, including the terms of both the new and refinanced loans, the cost of the new loan, and the borrower's circumstances. In addition, the following home loan refinancings shall be presumed to be flippings if:

- (1) The primary tangible benefit to the borrower is an interest rate lower than the interest rate(s) on debts satisfied or refinanced in connection with the home loan, and it will take more than four (4) years for the borrower to recoup the costs of the points and fees and other closing costs through savings resulting from the lower interest rate; or*
- (2) The new loan refinances an existing home loan that is a special mortgage originated, subsidized, or guaranteed by or through a state, tribal or local government, or nonprofit organization, which either bears a below-market interest rate at the time the loan was originated, or has nonstandard payment terms beneficial to the borrower, such as payments that vary with income, are limited to a percentage of income, or where no payments are required under specified conditions, and where, as a result of the refinancing, the borrower will lose one (1) or more of the benefits of the special mortgage.*

- (c) Recommendation of Default. No creditor shall recommend or encourage default on an existing loan or other debt prior to and in connection with the closing or planned closing of a home loan that refinances all or any portion of such existing loan or debt.*
- (d) Late Fees. No creditor may charge a late payment fee except according to the following rules:*
 - (1) The late payment fee may not be in excess of four percent (4%) of the amount of the payment past due.*
 - (2) The fee may only be assessed for a payment past due for fifteen (15) days or more.*
 - (3) The fee may not be charged more than once with respect to a single late payment. If a late payment charge is deducted from a payment made on the loan, and such deduction causes a subsequent default on a subsequent payment, no late payment charge may be imposed for such default. If a late payment charge has been once imposed with respect to a particular late payment, no such charge shall be imposed with respect to any future payment which would have been timely and sufficient, but for the previous default.*
 - (4) No fee may be charged unless the creditor notifies the borrower within forty-five (45) days following the date the payment was due that a late payment charge has been imposed for a particular late payment. No late payment charge may be collected from any borrower if the borrower informs the creditor that nonpayment of an installment is in dispute and presents proof of payment within forty-five (45) days of receipt of the creditor's notice of the late charge.*
 - (5) The creditor shall treat each and every payment as posted on the same date as it was received by the creditor, servicer, creditor's agent, or at the address provided to the borrower by the creditor, servicer, or the creditor's agent for making payments.*
- (e) Call Provision Prohibition. No home loan may contain a provision that permits the creditor, in its sole discretion, to accelerate the indebtedness. This provision does not prohibit acceleration of the loan in good faith due to the borrower's failure to abide by the material terms of the loan.*

(f) *Fee for Balance.* No creditor may charge a fee for informing or transmitting to any person the balance due to pay off a home loan or to provide a release upon prepayment. Payoff balances shall be provided within a reasonable time, but in any event no more than seven (7) business days after the request.

**Commentary:
Prohibited
Acts and
Practices
Regarding
Home Loans**

Section 3 limits six lending practices applicable to all home loans (as defined by the Model Act), regardless of whether the loans are high-cost loans. The late fee limitation in Subsection (d) states a fair rule for the collection of fees for late payments. All of the other acts are inherently abusive and are rarely included in conventional loans. These are unnecessary to facilitate credit availability, and prohibiting them appropriately protects home ownership and home equity without limiting borrowers' access to credit.

(a) Prohibition of Financing Credit Insurance Premiums and Debt Cancellation Agreements. This provision addresses one of the most costly abuses in home lending. Abusive lenders often finance single-premium credit insurance, generally receiving substantial immediate compensation for selling the insurance. The lender generally induces the borrower to initial a form at closing, sometimes without the borrower realizing that single-premium credit insurance has been added to the loan agreement. The lender then adds the credit insurance premium to the principal, thus charging interest and points on the credit insurance premium.

Subprime borrowers who finance credit insurance and then refinance the loan have paid for credit insurance coverage (as well as interest) for a period beyond the life of the loan. Alternatively, by purchasing credit insurance on a monthly basis, a borrower avoids unnecessary coverage and interest beyond the life of loan. Credit insurance only makes economic sense for the borrower when it is offered on a "monthly outstanding balance" basis, and this is far preferable to the inclusion of a large single-premium for credit insurance in the loan balance. Purchasing credit insurance on a monthly outstanding balance basis prevents the credit insurance premium from further stripping home equity, and because the insurance is paid for on a monthly basis, it can be cancelled immediately by the borrower when the borrower no longer wants/needs the insurance. The result is that while the borrower is still covered by credit insurance, the monthly costs to the borrower, and the overall cost for this product, are both substantially lower. The Center for Economic Justice compared the cost of financed, single-premium insurance to a monthly outstanding balance insurance product using a hypothetical \$30,000 loan with a ten-year term and 15 percent interest rate and industry-standard insurance rates. Over the lifetime of the loan, the borrower pays \$6,515 for financed, single-premium insurance (including finance charges), compared with \$1,747 for the monthly credit insurance product.

While credit insurance guarantees payment of the loan in the case of the borrower's death, unemployment, or disability, so that the loss of income does not displace dependents (children, spouse) from the home, questions also have been raised regarding the suitability of credit insurance product sales. For example, a growing number of older, single women have been sold financed single-premium credit insurance.

North Carolina and Illinois ban financed, single-premium insurance on high-cost loans, while the District of Columbia and Massachusetts restrict the

practice. The Federal Reserve Board has recognized the significant problems with credit insurance and has proposed the inclusion of the cost of single-premium credit insurance and related products in the points and fees trigger for HOEPA.

The Model Act includes limitations on financing of credit insurance labeled as insurance as well as similar products such as debt cancellation agreements. Debt cancellation agreements are simply additional terms in the credit contract whereby, for a fee, the lender agrees to forgive the borrower's monthly payment for a period of time upon occurrence of an event such as the death, disability, or unemployment of the borrower. To the borrower, there is little difference between credit insurance and debt cancellation agreements. (The borrower is even less protected under these agreements. The price and terms are completely unregulated in most states, as they are not technically insurance. There is no third-party insurer involved in the transaction.) The Federal Reserve and the Office of the Comptroller of the Currency (OCC, the federal regulator of national banks) have allowed lenders to treat these agreements in a manner similar to single-payment credit insurance premiums. It is important that debt cancellation agreements are included in the scope of this prohibition against financing credit insurance premiums to prevent unscrupulous lenders from using debt cancellation agreements to evade the prohibition.

- (b) **Flipping Prohibition.** Flipping occurs when a loan is refinanced repeatedly, with new up-front fees imposed on each refinancing, providing little tangible benefit to the borrower. Flipping strips the homeowner's equity by substantially increasing the amount borrowed each time the loan is refinanced. At the same time, the borrower receives little in the way of additional credit or cash. The Model Act requires that each refinancing have a "reasonable, tangible net benefit" to the borrower as determined by all of the circumstances of the loan, including the terms of the new and refinanced loan, the cost of the loan, and the borrower's individual circumstances.

The general prohibition includes two circumstances under which refinancing will be presumed to be illegal flipping. Under Subsection 1, refinancing is presumed to be flipping if the primary tangible benefit to the borrower is interest rate reduction *and* it will take more than four years for the borrower to recoup the costs of obtaining the lower rate loan. Because this recoupment can only occur through savings in monthly payments, the up-front fees charged on the new loan have to be amortized over the course of four years (48 months). If these fees are not paid off within 48 months, then the lower interest rate did not justify the loan, because while the borrower may have slightly lower monthly payments, they come at the expense of increasing the loan principal to pay closing costs, thereby stripping equity from the home. Like the "bona fide points" standard, this provision sets an objective standard whereby a determination can be made about whether an interest rate reduction provides a sufficient benefit to the borrower.

The second category of flipped refinancings is the refinancing of special mortgage loans that carry below-market rates or other payment terms beneficial to the borrower. These loans are generally mortgages used to purchase homes for first-time homebuyers (for example, loans provided through the Department of Veterans Affairs and Habitat for Humanity) who could not attain homeownership without a special program. Generally, these

loans have below-market interest rates and reasonable or subsidized closing costs. This provision is intended to prohibit lenders from refinancing these loans with higher-rate loans.

The Federal Reserve has recognized the problems caused by flipping and specifically requires that a “totality of the circumstances” standard apply. The North Carolina law includes a provision similar to, but less specific than, the language in the Model Act. New York and Massachusetts do not allow any points or fees in a refinancing by the same lender within 24 months, or on any refinancing of a high-cost loan using a mortgage broker. Texas addresses the issue by restricting the total value of loans secured by the home to 80 percent of home value.

- (c) **Encouraging Default.** This provision prohibits a lender from encouraging default on an existing debt in the course of refinancing. This protection is necessary to address a widespread practice in which borrowers are pressured into accepting abusive loans which must be closed immediately to avoid foreclosure on an existing loan. Unscrupulous lenders often advise borrowers to stop making payments on existing debt because it will all be refinanced when the new loan is closed. When the borrower arrives at the loan closing, the existing debt has gone into default. The borrower must now close the new loan, even if the terms have become much more unfavorable, because of the pressure of being in default on his or her other credit. This term is modeled after the provision in the North Carolina Predatory Lending Act. The District of Columbia, Massachusetts, and Virginia also prohibit this practice.
- (d) **Late Payment Charges.** Excessive late fees are prohibited, as is imposition of multiple late fees resulting from a single late or missed payment. These practices make it difficult or impossible for borrowers to recover from a short-term financial setback and can quickly drain equity from a home. This subsection also requires the lender to treat a payment as posted on the day it is received. This provision addresses the practice of delaying the posting of payments that are physically received by the lender, but not processed promptly. In such instances, late payments are incurred, even though the payment was not late. Lenders derive substantial profits from late payments, giving unscrupulous lenders an incentive to inappropriately post payments late. Many state laws already include limitations on late payment fees, and the basic structure of the limitation in this Model Act follows the one recommended by the Federal Trade Commission in the Credit Practices Rule.
- (e) **Call Provision Prohibition.** Call provisions permit a lender to accelerate the loan at the lender’s discretion and demand payment of the entire loan balance. A call provision can be used to force a borrower to refinance the loan and incur additional points and up-front fees associated with refinancing. Also, lenders can use a call provision to unfairly force a borrower to refinance when interest rates rise, requiring the borrower to refinance at the higher interest rate. Virginia, Massachusetts, and New York similarly prohibit this practice. North Carolina’s statute includes a call provision, but only for “high-cost home loans.” New Federal Reserve rules, if adopted as proposed, would include a call provision for HOEPA loans. Texas prohibits calls based on reduced value of property or junior lien defaults.
- (f) **Fee for Balance.** This section prevents two unscrupulous practices that deter borrowers from obtaining better credit: 1) untimely delivery of payoff

information, and 2) untimely release of the note of indebtedness at prepayment. Without the timely release of these two items, borrowers can be hindered from refinancing with a lower-cost lender. The Model Act provides a reasonable amount of time for the lender to respond to a payoff request or release (seven days), and prohibits a charge for the payoff request or release, including facsimile fees or other similar charges. The Act specifically includes reasonable time for release should the state's existing law not include this provision.

**Section 4.
LIMITATIONS
AND
PROHIBITED
PRACTICES
FOR
HIGH-COST
HOME LOANS**

A high-cost home loan shall be subject to the following additional limitations and prohibited practices:

- (a) ***No Financing of Fees or Charges.*** No creditor making a high-cost home loan shall directly or indirectly finance any points or fees.
- (b) ***Prepayment Penalties Limited.*** No prepayment fees or penalties shall be included in the loan documents for a high-cost home loan or charged the borrower which exceed in the aggregate: 1) in the first 12 months after the loan closing more than two percent (2%) of the loan amount prepaid, or 2) in the second 12 months after the loan closing, more than one percent (1%) of the amount prepaid. No prepayment penalty shall be contracted for after the second year following the loan closing.
- (c) ***No Balloon Payment.*** No high-cost home loan may contain a scheduled payment that is more than twice as large as the average of earlier scheduled payments. This provision does not apply when the payment schedule is adjusted to the seasonal or irregular income of the borrower.
- (d) ***No Negative Amortization.*** No high-cost home loan may include payment terms under which the outstanding principal balance will increase at any time over the course of the loan because the regular periodic payments do not cover the full amount of interest due.
- (e) ***No Increased Interest Rate.*** No high-cost home loan may contain a provision that increases the interest rate after default. This provision does not apply to interest rate changes in a variable rate loan otherwise consistent with the provisions of the loan documents, provided the change in the interest rate is not triggered by the event of default or the acceleration of the indebtedness.
- (f) ***No Advance Payments.*** No high-cost home loan may include terms under which more than two (2) periodic payments required under the loan are consolidated and paid in advance from the loan proceeds provided to the borrower.
- (g) ***No Mandatory Arbitration Clause.*** No high-cost home loan may be subject to a mandatory arbitration clause that limits in any way the right of the borrower to seek relief through the judicial process for any and all claims and defenses the borrower may have against the creditor, broker, or other party involved in the loan transaction.

- (h) **No Lending without Homeownership Counseling.** A creditor may not make a high-cost home loan without first receiving certification from a counselor approved by the United States Department of Housing and Urban Development (HUD), a state housing financing agency, or the regulatory agency which has jurisdiction over the creditor, that the borrower has received counseling on the advisability of the loan transaction.

- (i) **No Lending without Due Regard to Repayment Ability.** A creditor may not make a high-cost home loan without due regard to repayment ability. A creditor who follows the debt-to-income ratio listed in 38 C.F.R. § 36.4337(c)(1) and as defined in 38 C.F.R. § 36.4337(d) and follows the residual income guidelines established in 38 C.F.R. § 36.4337(e) and VA Form 26-6393 shall benefit from a rebuttable presumption that the creditor made the loan with due regard to repayment ability.

- (j) **Home-Improvement Contracts.** A creditor may not pay a contractor under a home-improvement contract from the proceeds of a high-cost home loan, unless:
 - (1) The creditor is presented with a signed and dated completion certificate showing that the home improvements have been completed; and
 - (2) The instrument is payable to the borrower or jointly to the borrower and the contractor, or, at the election of the borrower, through a third-party escrow agent in accordance with terms established in a written agreement signed by the borrower, the creditor, and the contractor prior to the disbursement.

- (k) **No Modification or Deferral Fees.** A creditor may not charge a borrower any fees or other charges to modify, renew, extend, or amend a high-cost home loan or to defer any payment due under the terms of a high-cost home loan.

- (l) **Judicial Foreclosure or Determination.**

Judicial Foreclosure. [Option A—in states which have a judicial foreclosure process] Any creditor making a high-cost home loan that has the legal right to foreclose must use the judicial foreclosure procedures of the state wherein the property securing the loan is located. The borrower shall have the right to assert in such proceeding the nonexistence of a default and any other claim or defense to acceleration and foreclosure, including any based on any violations of this Act, though no such claim or defense shall be deemed a compulsory counterclaim.

Judicial Determination. [Option B—in states which do not have a full judicial foreclosure process] Prior to invoking a nonjudicial power of sale or any other nonjudicial remedy available under applicable law, a creditor making a high-cost home loan must first obtain a declaratory judgment in a court of competent jurisdiction providing that: 1) the creditor is the proper party in interest to invoke the power of sale or other remedy; and 2) the grounds for exercising the power of sale or other remedy have been fully satisfied. The borrower shall have the right to assert in such proceeding the nonexistence of a default and any other claim or defense to acceleration and foreclosure, including any based on any violations of this Act, though no such claim or defense shall be deemed a compulsory counterclaim.

**Commentary:
Limitations
and
Prohibited
Practices for
High-Cost
Home Loans**

A MODEL STATE STATUTE

Section 4 lists 12 additional restrictions on loans that exceed the thresholds for interest rate or points and fees. These loans are already costly, and the additional protections are designed to protect consumers from the most onerous lending practices and, through counseling, to assist borrowers to understand the terms and advisability of the loan before it is consummated.

- (a) **No Financing of Fees or Charges.** This is the single most important provision of the Model Act. This provision encourages the lender to recoup the cost of making the loan through the regular repayment schedule rather than through high up-front costs. Borrowers are less likely to take a more expensive loan if they have to pay high fees out-of-pocket. North Carolina law also prohibits the financing of fees.
- (b) **Limitation of Prepayment Penalties.** If the loan has high fees and/or points, the lender generally realizes significant profits from the points and fees. Because the costs of making the loan have likely been included in the up-front points and fees, there is little fiscal justification for also charging prepayment penalties. Therefore, the Model Act limits prepayment penalties on high-cost loans to two percent of the loan amount prepaid in the first year, one percent of the loan amount prepaid in the second year, and none thereafter. As described in Section 2(i)(3), prepayment penalties are limited to prevent equity stripping, flipping, and the facilitation of YSPs.
- (c) **No Balloon Payment.** Inappropriate balloon payments are a widespread practice among predatory lenders. Unscrupulous lenders structure some loans so that the monthly payments only pay interest without paying any or just a small amount of the principal, with a large lump-sum (that is, balloon) payment due at the end of the term for the amount originally borrowed. Often borrowers are not aware of the balloon payments, or if the lender does explain the balloon payment feature, the borrower is assured that the lender will refinance the balloon payment when it becomes due. Conventional borrowers sometimes do have balloon payments, deliberately taking on the risk of refinancing in return for a lower interest rate and lower monthly payments, or for example, in cases where a borrower expects to receive a large sum of money in the future (such as inheritance). However, high-cost borrowers who sign a loan with a balloon payment often do so without a full understanding of its implications or without the expectation of a future lump sum of money. Instead, their financial situation is greatly harmed by pressure to refinance (with additional up-front fees) or the threat of foreclosure when the balloon payment is late.

HOEPA includes a limitation on balloon payments for high-cost loans; balloon terms in the first five years are prohibited. North Carolina's statute prohibits any scheduled payment more than twice as large as the average of earlier scheduled payments. The District of Columbia, Massachusetts, and New York limit balloons until after seven years; Illinois allows balloon payments after 15 years.

- (d) **No Negative Amortization.** Negative amortization loans have monthly payments which cover only a part of the total periodic interest due each month and *none* of the principal. This results in an *increasing* principal balance on the loan, even though the borrower makes monthly payments. The Model Act prohibits a negative amortization loan structure for high-cost loans, except in cases where the borrower seeks a temporary reduction in payment as part of

a forbearance plan. HOEPA and some states, including North Carolina and Massachusetts, prohibit negative amortization for all high-cost loans.

- (e) **No Increased Interest Rate.** This subsection prohibits loan provisions that increase the interest rate after default. On high-cost loans, the existing interest rate is high, and there is no justification for an increase in the rate upon default. The District of Columbia, Massachusetts, New York, North Carolina, and HOEPA all prohibit a higher interest rate after default on high-cost loans.
- (f) **No Advance Payments.** This provision prohibits lenders of high-cost loans from structuring these loans so that more than two periodic payments are paid in advance from the loan proceeds. The use of advance payments raises two concerns. First, payments can be used by unscrupulous lenders to mask a loan that is being made to the borrower who has no reasonable prospect of repaying the loan. By creating this initial reserve of advance payments, unscrupulous lenders use the reserve to keep the loan current for a period and make it appear that the borrower can afford the loan payments. Second, because these payments are deducted from the proceeds received by the borrower, the borrower is paying interest on funds that the lender is using. HOEPA, Massachusetts, New York, and North Carolina prohibit advance payments on high-cost loans.
- (g) **No Mandatory Arbitration Clause.** Increasingly, lenders are including mandatory arbitration clauses in their loan contracts, though borrowers are seldom aware of these provisions. These clauses are designed to make it difficult or impossible for consumers to raise legitimate disputes with the lender. Often, the arbitration clause will contain anticonsumer provisions that limit the consumer's remedies, prohibit class actions, or designate an arbitrator that is biased toward the lender. In addition, arbitration can involve costly fees or be required to take place at a distant site. Consumers must be allowed to use the courts to raise claims involving their mortgages, particularly when the mortgage is a high-cost loan. The Federal Arbitration Act limits the ability of states to prohibit arbitration clauses, so the Model Act provision is limited. The District of Columbia prohibits mandatory arbitration clauses, and Massachusetts and New York restrict the practice.
- (h) **No Lending without Homeownership Counseling.** Many borrowers of high-cost loans do not realize they are qualified for lower-cost loans and may not be aware of the many costly fees and terms of the loan. This provision requires that an objective, trained counselor review any high-cost loan with the prospective borrower before closing. Such interventions can discourage abusive loans. The Model Act's Homeownership Counseling provision is similar to the counseling provision in North Carolina's law.
- (i) **No Lending without Due Regard to Repayment Ability.** The practice of lending to borrowers who have no reasonable prospect of being able to repay a loan, but who have substantial equity in their homes, is abusive. These loans are designed to strip the borrower's equity through repeated refinancings, which lead to foreclosure. The Model Act prohibits asset-based lending for high-cost loans. HOEPA prohibits lenders from engaging in a pattern or practice of extending credit without ability to repay.

Both the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA) have developed income underwriting guidelines for high-risk mortgage borrowers. VA guidelines include an assessment of “residual income” for low-income borrowers. Residual income becomes important because even reasonable debt-to-income ratios leave low-income borrowers with very few dollars in absolute terms to pay for utilities, food, transportation, and other basic needs. The VA has established amounts for different regions and family sizes that represent the minimum required residual income after subtracting mortgage, utility, and work-related expenses. A safe harbor is provided under the Model Act for lenders who follow the debt-to-income ratios listed in 38 C.F.R. § 36.4337(c) and follow the residual income guidelines as defined in 38 C.F.R. § 36.4337(d). With some exceptions, these regulations permit loans in which borrowers spend up to 41 percent of their monthly income to cover long-term debt—including the mortgage payment—as long as there is residual income to cover necessities.

Laws in North Carolina and Illinois state that all monthly debt payments cannot exceed 50 percent of a debtor’s monthly gross income. Massachusetts and New York have a 50 percent debt test for borrowers with incomes under 120 percent of median income.

- (j) **Restrictions on Home-Improvement Contracts.** Another prohibited practice under this section involves abusive lenders working with fraudulent home-improvement contractors. For example, a contractor sends the borrower to the lender for a high-cost loan, and the lender pays the contractor directly for work that is poorly done or never completed. The Model Act requires the lender to issue loan proceeds checks jointly to the borrower and the contractor or to a third-party escrow agent, and only after a certification of completion has been signed showing that the home improvements have been completed. This prevents the contractor from receiving the payment without the consent of the borrower. Protections for home-improvement borrowers are further enhanced by the provisions regarding preservation of defenses in Section 6. Illinois, Massachusetts, New York, North Carolina, and HOEPA require payment be made to the borrower or a third-party escrow agent.
- (k) **No Modification or Deferral Fees.** This provision prohibits a lender from charging any fees to modify, renew, extend, or amend a high-cost loan. Further fees are not justified if the loan has such high fees and/or rates that it is classified as a high-cost loan under the Model Act. Massachusetts, New York, and North Carolina restrict modification and deferral fees.
- (l) **Restrictions on Foreclosure Proceedings.** This provision requires lenders of high-cost loans to use state judicial foreclosure proceedings, if available, rather than following a nonjudicial or power of sale foreclosure process. If there is no state judicial foreclosure process, then before invoking any nonjudicial remedy, the lender must obtain a declaratory judgment from a court of competent jurisdiction that the lender has the legal right to foreclose. This provision is intended to ensure that borrowers of high-cost loans will always have an opportunity to raise any legal defenses they may have before their homes are lost to foreclosure. The District of Columbia and Texas also require a judicial process before foreclosure.

**Section 5.
RIGHT TO
CURE**

**MODEL
STATUTE**

- (a) **Right to Reinstate.** *If a creditor asserts that grounds for acceleration exist and requires the payment in full of all sums secured by the security instrument, the borrower, or anyone authorized to act on the borrower's behalf, shall have the right at any time, up to the time title is transferred by means of foreclosure, by judicial proceeding and sale or otherwise, to cure the default, and reinstate the home loan by tendering the amount or performance as specified herein. Cure of default as provided herein shall reinstate the borrower to the same position as if the default had not occurred and shall nullify, as of the date of the cure, any acceleration of any obligation under the security instrument or note arising from the default.*
- (b) **Grounds for Reinstatement.** *Before any action filed to foreclose upon the home or other action is taken to seize or transfer ownership of the home, a notice of the right to cure the default must be delivered to the borrower informing the borrower of the following:*
- (1) *The nature of default claimed on the home loan, and of the borrower's right to cure the default by paying the sum of money required to cure the default, provided that a creditor or servicer may not refuse to accept any partial payment made or tendered in response to said notice. If the amount necessary to cure the default will change during the thirty (30)-day period after the effective date of the notice, due to the application of a daily interest rate or the addition of late fees, as allowed by this Act, the notice shall give sufficient information to enable the borrower to calculate the amount at any point during the thirty (30)-day period;*
 - (2) *The date by which the borrower shall cure the default to avoid acceleration and initiation of foreclosure, or other action to seize the home, which date shall not be less than thirty (30) days after the date the notice is effective, and the name and address and telephone number of a person to whom the payment or tender shall be made;*
 - (3) *That if the borrower does not cure the default by the date specified, the creditor may take steps to terminate the borrower's ownership in the property by requiring payment in full of the home loan and commencing a foreclosure proceeding or other action to seize the home; and*
 - (4) *The name and address of the creditor and the telephone number of a representative of the creditor whom the borrower may contact if the borrower disagrees with the creditor's assertion that a default has occurred or the correctness of the creditor's calculation of the amount required to cure the default.*
- (c) **Fees.** *To cure a default under this subsection, a borrower shall not be required to pay any charge, fee, or penalty attributable to the exercise of the right to cure a default as provided for in this section, other than the fees specifically allowed by this section. The borrower shall not be liable for any attorney fees relating to the borrower's default that are incurred by the lender prior to or during the 30-day period set forth in Subsection (b) (2) of this section, nor for any such fees in excess of \$100 that are incurred by the lender after the expiration of the 30-day period but prior to the time the lender files a foreclosure action or takes other action to seize or transfer ownership of the home. After the lender files a foreclosure action or takes other action to seize or transfer ownership of the home, the borrower shall only be liable for attorney fees that are reasonable and actually incurred by the lender, based on a reasonable hourly rate and a reasonable number of hours.*

(d) **Enforcement of Security Instrument.** *If a default is cured prior to the initiation of any action to foreclose or to seize the residence, the creditor shall not institute the foreclosure proceeding or other action for that default. If a default is cured after the initiation of any action to foreclose, the creditor shall take such steps as are necessary to terminate the foreclosure proceeding or other action. Any creditor making a home loan who has the legal right to foreclose must use the judicial foreclosure procedures of the state wherein the property securing the loan is located. The borrower shall have the right to assert in a judicial foreclosure proceeding or other action the nonexistence of a default and any other claim or defense to acceleration and foreclosure, including any based on violations of this Act, though no such claim or defense shall be deemed a compulsory counterclaim.*

**Commentary:
Right to Cure**

Section 5 establishes a right to cure a default and reinstate a mortgage by tendering the amount due before any acceleration. Before an action to foreclose is filed, the lender must give the borrower a notice of the right to cure, containing the amount that must be paid to cure the default. A borrower shall have 30 days from the effective date of the notice to cure the default. The lender must give the borrower sufficient information in the notice to calculate the amount due at any time during the 30-day period. The notice also must clearly state the name, address, and telephone number of the person to whom the payment should be made, and the date by which it should be made. Finally, the notice must inform the borrower of the name, address, and telephone number of a representative of the lender whom the borrower can contact if the borrower disagrees with the lender’s claim of default.

Fees attributable to the exercise of the right to cure also are strictly limited by Subsection (c) of this provision.

**Section 6.
PRESERVATION
AND
ENFORCEMENT
OF CLAIMS
AND
DEFENSES,
NO
SUBTERFUGE**

-
- (a) **Claims against Sellers.** *Notwithstanding any other provision of law, where a home loan was made, arranged, or assigned by a person selling either a manufactured home, or home improvements to the dwelling of a borrower, the borrower may assert all affirmative claims and any defenses that the borrower may have against the seller or home-improvement contractor against the lender, any assignee, holder, or servicer, in any capacity.*
 - (b) **Liability of Assignees and Other Holders in High-Cost Home Loans.** *Notwithstanding any provision of any other law, the remedies provided herein apply to the creditor, any director, officer, employee, or controlling stockholder of, or agent for, a creditor who personally participated in the making or approving of a high-cost home loan, and any other persons to whom this Act applies and who violated the requirements of this Act. Any person who purchases or is otherwise assigned a high-cost home loan shall be subject to all affirmative claims and any defenses with respect to the loan that the borrower could assert against the original creditor or broker of the loan.*
 - (c) **Liability of Assignees in Foreclosure Action.** *Notwithstanding any provision of any other law, a borrower in default more than sixty (60) days or in foreclosure may assert a violation of this Act by way of offset:*

Commentary:
Preservation
and
Enforcement
of Claims and
Defenses, No
Subterfuge

- (1) *As an original action;*
- (2) *As a defense or counterclaim to an action to collect amounts owed; or*
- (3) *To obtain possession of the home secured by the home loan.*

(d) **No Subterfuge.** *It is a violation of this Act, for any person, who in bad faith attempts to avoid the application of this Act by:*

- (1) *Dividing any loan transaction into separate parts for this purpose, or*
- (2) *Any other such subterfuge, with the intent of evading the provisions of this Act.*

(a) **Claims against Sellers.** The purpose of this provision is to ensure that when a loan is made by a person selling a manufactured home or providing home improvements, borrowers can raise all claims they may have against the seller and any holders of notes. This section is intended to reach warranty type claims, and other seller-related claims that otherwise may be limited by the holder in due course doctrine. For example, a borrower who receives a warranty for home-improvement work should retain the protections of the warranty even if the loan originator (the home-improvement contractor, for instance) sells the loan. This provision is similar to the FTC Rule concerning preservation of consumer’s claims and defenses and is intended to cover “any understanding, procedure, course of dealing, or arrangement between a creditor and a seller, in connection with the sale of goods or services to consumers or the financing thereof” 16 C.F.R. § 433.1(g).

(b) **Liability of Assignees and Other Holders of High-Cost Loans.** This provision ensures that borrowers with high-cost loans can raise all claims regarding the loan against the original lender, the broker, and any entity currently holding the note. It prevents lenders from avoiding liability for their bad acts by selling the loan, and will reduce significantly the amount of credit that is available to lenders who are not willing to ensure that loans they finance are made in accordance with the law. This language is similar to the extended liability language in HOEPA, which requires that all claims a borrower may have can be brought against the holder of the loan. Laws in the District of Columbia and Massachusetts extend liability to the assignee or purchasee of the loan. Without an extended liability provision in the Model Act, a number of the other provisions ultimately are unenforceable in many situations.

(c) **Liability of Assignees in Foreclosure Actions.** This provision provides that all borrowers can raise violations of the Model Act in defense of foreclosure actions.

(d) **No Subterfuge.** Lenders may try to restructure transactions to evade the protections of the Model Act, such as by using sham loan structures. The Model Act makes such practices illegal.

(a) **Civil.**

- (1) *Any violation of this Act constitutes a violation of any state law prohibiting unfair or deceptive trade practices.*

Section 7.
ENFORCEMENT

- (2) Any person found by a preponderance of the evidence to have violated this Act shall be liable to the borrower for the following:
- (A) Actual damages, including consequential and incidental damages; the borrower shall not be required to demonstrate reliance in order to receive actual damages;
 - (B) Statutory damages equal to the finance charges agreed to in the home loan agreement, plus ten percent (10%) of the amount financed;
 - (C) Punitive damages, when the violation was malicious or reckless; and
 - (D) Costs and reasonable attorneys' fees.
- (3) A borrower may be granted injunctive, declaratory, and such other equitable relief as the court deems appropriate in an action to enforce compliance with this Act.
- (4) The intentional violation of this Act, or regulation thereunder, renders the home loan agreement void, and the creditor shall have no right to collect, receive, or retain any principal, interest, or other charges whatsoever with respect to the loan, and the borrower may recover any payments made under the agreement.
- (5) The right of rescission granted under 15 U.S.C. 1601 et seq. for violations of that law and all other remedies provided hereunder shall be available to a borrower by way of recoupment against a party foreclosing on the home loan or collecting on the loan, at any time during the term of the loan.
- (6) The remedies provided in this section are not intended to be the exclusive remedies available to a borrower, nor must the borrower exhaust any administrative remedies provided under this Act or any other applicable law before proceeding under this section.
- (b) **Criminal.** Any person, including members, officers, and directors of the creditor, who knowingly violates this Act is guilty of a misdemeanor and, on conviction, is subject to a fine not exceeding \$1,000 or to imprisonment not exceeding six (6) months, or both.
- (c) **Corrections and Unintentional Violations.** A creditor in a home loan who, when acting in good faith, fails to comply with the provisions of this Act, will not be deemed to have violated this section if the creditor establishes that either:
- (1) Within thirty (30) days of the loan closing, and prior to receiving any notice from the borrower of the compliance failure, the creditor has made appropriate restitution to the borrower, and appropriate adjustments are made to the loan; or
 - (2) Within sixty (60) days of the loan closing and prior to receiving any notice from the borrower of the compliance failure, and the compliance failure was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid such errors, the borrower is notified of the compliance failure, appropriate restitution is made to the borrower, and appropriate adjustments are made to the loan.

Examples of bona fide errors include clerical, calculation, computer malfunction and programming, and printing errors. An error of legal judgment with respect to a person's obligations under this section is not a bona fide error.

- (d) **Cumulative.** The remedies provided herein are cumulative.

Section 7 establishes remedies for violations of the Model Act.

**Commentary:
Enforcement**

- (a) **Civil Remedies.** Loans that violate the Model Act are declared to be unfair or deceptive trade practices. The Model Act provides for actual damages, including consequential and incidental damages, statutory damages equal to the finance charge stated in the loan contract, plus ten percent of the finance charge, and attorney fees and costs. The Model Act also authorizes injunctive relief. The damages provided for under the Model Act are patterned after the damages allowed under Article 9 of the Uniform Commercial Code.

In addition, the Model Act provides a remedy similar to the rescission remedy provided in TILA, but without the complex procedural requirements of TILA rescission. Under the Model Act, this remedy is only provided for an intentional violation of the Model Act or its regulations; whereas under TILA the remedy is available for any failure to make a material disclosure equal to a certain amount regardless of the intent of the lender. However, unlike TILA, a violation renders the loan void. The creditor is not allowed to collect any amounts under the loan, and the borrower is entitled to the return of any monies paid in accordance with the loan. Finally in Section 7(a)(5), the Model Act establishes a state right of rescission mirroring the rescission rights under TILA, which are available for the term of the loan.

The Model Act also makes explicit that its provisions are supplemental to other consumer protections available under the law—both other statutes and common law protections such as claims for fraud. North Carolina and Virginia allow the judge discretion to impose “reasonable” attorney’s fees for the winning side in a dispute. The District of Columbia also includes a provision for actual damages.

- (b) **Criminal Sanctions.** This section makes intentional violations of the Model Act criminal acts subject to fines up to \$1,000 and/or up to six months’ imprisonment.
- (c) **Corrections and Unintentional Violations.** The Model Act provides protection to lenders for inadvertent errors made while acting in good faith. This provision, similar to that in TILA, is intended to encourage assignees to conduct due diligence reviews of loans for compliance with the Model Act’s provisions. Lenders are allowed to correct any noncompliance within 30 days, and before receiving notice of the violation from the borrower, by making restitution to the borrower of any amounts collected in error and making any necessary adjustments to the loan. In addition, if the noncompliance was unintentional and resulted from a bona fide error, and the lender maintains reasonable procedures to avoid such errors, the lender has up to 60 days from the loan closing to correct the error and avoid liability. Massachusetts, New York, North Carolina, and the District of Columbia offer similar safeguards for the lender.
- (d) **Remedies are Supplemental.** The Model Act also provides that its remedies are supplemental to other consumer protections available under the law—both other statutes and common law protections such as claims for fraud.

**Section 8.
RIGHTS IN
ADDITION TO
OTHER LAWS**

The rights conferred by this section are independent of and in addition to any other rights under other laws.

**Commentary:
Rights in
Addition to
Other Laws**

The Model Act makes it explicit that the rights of consumers under the Model Act are supplemental to the rights under other laws, and the Model Act does not repeal those other rights.

**Section 9.
SEVERABILITY**

The provisions of this Act shall be severable, and if any phrase, clause, sentence, or provision is declared to be invalid or is preempted by federal law or regulation, the validity of the remainder of this act shall not be affected thereby. If any provision of this Act is declared to be inapplicable to any specific category, type, or kind of loan or points and fees, the provisions of this Act shall nonetheless continue to apply with respect to all other loans and points and fees.

**Commentary:
Severability**

The law is unsettled regarding the interaction of state and federal law regulating mortgage lending. Some federal laws may preempt some provisions of state laws that limit mortgage loan terms and practices. Therefore, it is very important for the Model Act to include a severability provision stating that if any portion of the law is determined to be preempted or otherwise invalid, the remainder of the Model Act will remain valid and in effect.

**Section 10.
APPLICABILITY**

The law of the state in which the property is located shall be applied to all transactions governed by this Act. This Act shall apply to all loans made or entered into after the effective date of this Act.

**Commentary:
Applicability**

This provision is intended to ensure that loans made by out-of-state lenders will be subject to the law of the state where the property is located.

The effective date need not be delayed. The time required for lenders to convert from single-premium financed insurance to monthly insurance should be minimal because federal actions have put lenders on notice that single-premium finance insurance is being phased out.

CITATIONS

District of Columbia:

D.C. Law 13-263 (1999); D.C. Act 13-552 (1999)

Illinois:

38 Ill. Adm. Code 160
38 Ill. Adm. Code 190
38 Ill. Adm. Code 345
38 Ill. Adm. Code 1000
38 Ill. Adm. Code 1050
38 Ill. Adm. Code 1075

Massachusetts:

209 CMR 40.00
209 CMR 42.00
209 CMR 32.32

New York:

3 NYCRR § 41.1-§ 41.9

North Carolina:

N.C. Gen. Stat. § 24-1.1E and § 24-10.2

Texas:

Tx. Const. Art. XVI § 50

Virginia:

Code of Va. Ch. 511 §§ 6.1-413, 6.1-422, 6.1-428; Ch. 510 § 6.1-422.1

Federal Arbitration Act:

9U.S.C. §§1-16



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