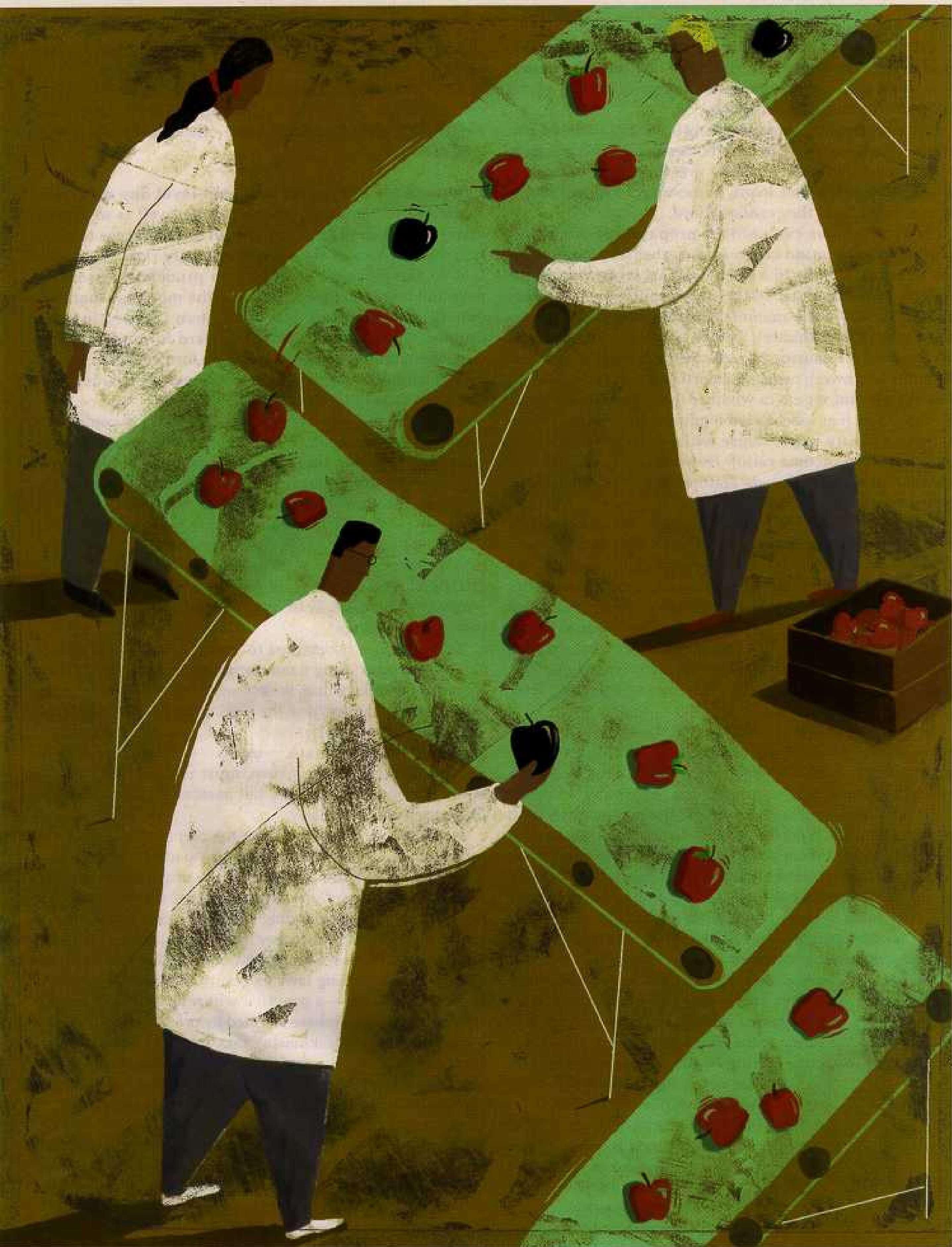
A Due Diligence Nightmare

CONDEMNATIONS OF PREDATORY LENDING GO WAY BACK. Since the Council of Nicea in 325 denounced it, Pope Leo the Great (440–461) declared it "shameful gain" and the Capitularies of Charlemagne (circa 800) defined it as "where more is asked than is given" and forbade it, predatory lending has pricked the social and political conscience. The consumer movement and consumer rights policy in government have furthered the borrower's cause. The result has been the rise of the notion *caveat emptor,* or buyer beware. Today we must add to this the significant corollary propositions of *caveat broquer* (broker beware) and *caveat venditor* (seller beware). Now *all* parties to the transaction are accountable for discovery and disclosure of material facts—the broker and the originator as well as those providing financing to the originator and secondary market purchasers of the loans.

Investors in subprime mortgages face a sobering task when it comes to detecting illegal predatory loans. At least 15 states, counties and cities have their own differing laws on banned high-cost loan provisions.

BY MARION LEE



The conundrum of predatory lending

Predatory lending may still be described, as it was by Lekmuhl in the 14th century, as "the abuse of a certain superiority at the expense of another man's necessity," but as a legal matter, the term eludes definition.

Predatory lending connotes loans to unsophisticated borrowers, who have equity in their homes but limited means to repay. Predatory lenders usually pressure these borrowers into high-cost refinance loans, home-equity loans or home-improvement loans they cannot afford.

Predatory loans can contain prepayment penalties; mandatory arbitration clauses (an agreement that waives the borrower's right to a jury trial; an arbitrator of the lender's choosing must settle loan disputes); packed fees (packing of fees in the amounts financed, such as single-premium credit life insurance); balloon payments; loan flipping (the frequent refinancing of a loan without tangible net benefit to the borrower); negative amortization or the extension of credit without regard to whether the borrower can repay the obligation (i.e., asset-based lending—lending money on the excess equity in the house without regard to the borrower's debt-to-income ratio). However, a loan could also contain one or more of these features and still be beneficial to the borrower.

"In some respects, the hitherto fruitless attempt to define predatory lending is reminiscent of Justice Stewart's famous comment about knowing pornography when he saw it," wrote Stephen F.J. Ornstein in a January 2001 company newsletter article entitled, *First Things First: Defining Predatory Lending.* "Defining predatory is not a mere matter of semantics. It involves striking a delicate balance between ensuring the flow of credit to low-to-moderate-income borrowers with blemished credit histories and counteracting egregious lending practices."

Ultimately, loans are "predatory" if the cost of the credit outweighs the benefit to the borrower. As a historical matter, predatory lending disproportionately afflicts protected classes of borrowers such as minorities, the elderly and women.

Nevertheless, predatory lending is not synonymous with subprime lending. When done responsibly, subprime lending often plays a legitimate and important role in making credit more available to credit-impaired borrowers, who ordinarily would not have access to credit. Subprime borrowers pay more because they cannot qualify for conventional financing because of blemished credit or atypical financial histories or circumstances.

There is also evidence that some consumers, regardless of whether they could qualify for conventional rates, are steered to high-cost home loans through aggressive, targeted marketing by some subprime lenders, or these consumers turn to subprime lenders because they have been overlooked, ignored or rejected by the mainstream financial industry. (Research conducted by Freddie Mac, *We Open Doors for America,* March 16, 1998, indicated that 10 percent to 30 percent of borrowers who obtained mortgages in the subprime market could have qualified for conventional loans through Loan Prospector®.)

Subprime due diligence, already dauntingly complex, is certain to become more so as additional laws and ordinances are enacted.

However, when a consumer pays excessive costs—costs not justified by the risk of the loan and costs that do not outweigh the benefit to the borrower—then the loan is considered predatory.

The need for corporate and loan-level due diligence

All parties to a mortgage transaction (as well as secondary-market purchasers of loans) rely on due diligence to ascertain the accuracy of data and to quantify risk. The parties look to due diligence providers for prudence, reasonableness and assiduousness. However, the mortgage market is constantly changing. Mortgage loan transactions are unique. There is no absolute standard for due diligence. Care, thoughtfulness and industry are insufficient to full discovery and disclosure. The due diligence provider must know the facts of the special case.

Subprime due diligence, already dauntingly complex, is certain to become more so as additional laws and ordinances are enacted. So far, there are 16 states and municipalities that have enacted a maze of overlapping and conflicting antipredatory laws that extend the consumer protections currently provided by the Fair Housing Act (FHA), the Equal Credit Opportunity Act (ECOA), the Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), the Real Estate Settlement Procedures Act (RESPA) and a panoply of other federal and state consumer compliance statutes.

Due diligence is destined to become more burdensome. The risk of purchasing a noncompliant loan, already greater than most people realize, is destined to rise. Providers of due diligence who do not have the tools or procedures to comply with these new laws—or worse, who are not fully abreast of all the relevant legal requirements—do their clients grave harm. Investors, in their turn, must not only be aware of antipredatory developments, but must also choose their due diligence providers wisely.

It is the law firm, performing the corporate due diligence on an originator, that looks for broad patterns of predatory lending. The law firm ensures that the originator is properly licensed, is not under investigation by federal and state regulators and is in good standing with these governmental entities, and is not subject to any significant private litigation. Additionally, the law firm determines whether the originator abides by fair lending laws to ensure there is no pattern of reverse redlining—a practice whereby low-income and minority communities are targeted by predatory lenders issuing high-priced loans, knowing they face no competition. (In contrast, redlining is a practice whereby banks exclude low-income and minority communities from consideration for prime-rate loans, literally by drawing red lines around them on the map).

The due diligence firm, on the other hand, performs loan-level analysis of the portfolio to uncover actual violations of law in individual loans. Such violations would include: churning or flipping (repeatedly financing the same loan within a short period to accumulate point and fee income); packing;

steering (when the originator "steers" the borrower to higher fees and interest rate than the borrower qualifies for); asset-based lending, stripping (using the borrower's home equity to collateralize the financing of points and fees and other charges) and unconscionable rates and terms.

The due diligence firm must make clear in its engagement contract that its scope of services will include the review of an originator's compliance with specifically enumerated laws, regulations and ordinances. The due diligence firm must also make clear that it will be the law firm's responsibility to detect broader patterns of predatory lending.

To undertake its tasks, the due diligence firm, first and foremost, must know the applicable federal, state and local laws and keep informed of legislative developments. The due diligence firm must maintain thorough and up-to-date software and procedures. Working with *last year's* software and hard-copy lists of *this year's* state and local triggers is woefully inadequate to the discovery of predatory-lending violations.

Due diligence software must contain programmed federal, state and municipal thresholds; an internal annual percentage rate (APR) formula for recalculating APR on adjustable-rate loans; online access to the Department of Housing and Urban Development's (HUD's) metropolitan statistical area (MSA) database; and updated Treasury indices. In addition, an attorney with a specialty in consumer law should review the software for completeness and accuracy and be retained to assist the firm with tricky day-to-day compliance issues that frequently arise during an assignment.

The due diligence firm should maintain written procedures for updating the software, as new laws are enacted. Further, the due diligence firm should have a philosophy as to what is antipredatory legislation and what it is not, since there are hundreds of bills that contain antipredatory provisions but are not as comprehensive as the measures adopted in states such as North Carolina.

The fullest disclosure and greatest protection for the investor is achieved when the law firm and the due diligence firm perform the corporate-level and loan-level due diligence contemporaneously and communicate to each other the results of their reviews.

On one occasion, a law firm asked a major lender for its policies and procedures for compliance with HOEPA, which the lender could not produce. Although the lender reassured the law firm of its adherence to HOEPA, the due diligence firm discovered high-cost home-improvement loans that contained payments made directly to contractors—a practice forbidden by HOEPA.

On another occasion, the due diligence firm discovered HOEPA disclosures that were improperly dated, making it impossible to confirm whether the borrower received the disbursements in a timely fashion. While there are no evidentiary standards for the HOEPA disclosure (i.e., no requirement that the borrower execute and date the disclosure), the law requires that the disclosure be provided to the borrower at least three business days prior to closing. When the due diligence firm alerted the law firm to this noncompliance, the law firm was able to confront the originator and confirm that the originator's HOEPA procedures were not foolproof.

The due diligence firm should maintain written procedures for updating the software, as new laws are enacted.

Antipredatory legislation: A study of three states

A review of the respective antipredatory provisions adopted in three important states—North Carolina, New York and Massachusetts—highlights the degree to which these measures have added restrictions not contained in the current HOEPA, lowered the thresholds for high-cost home loans and increased the peril to secondary-market investors.

North Carolina

North Carolina S.B. 1149 was enacted as Chapter 332 of the 1999 legislative session, ratified on July 15, 1999, and approved by Governor James B. Hunt on July 22, 1999. S.B. 1149 contains antipredatory loan provisions that became effective July 1, 2000. Other significant consumer protections pertaining to residential home loans became effective October 1, 1999. North Carolina set a precedent for combating predatory lending, creating the paradigm for other jurisdictions' antipredatory lending statutes.

North Carolina formed a consortium of 11 people representing government agencies, industry advocates and regulators, who worked nearly a year to develop a bill that would inhibit lending abuses without inhibiting lending. Unlike contentious legislative processes in other states, S.B. 1149 represented a cooperative effort among task-force members who were pledged to the principles of consumer rights.

While many North Carolina consumer-protection advocates perceive the legislation as eminently reasonable, some in the mortgage origination industry—who were reluctant to fault the initiative when it was being drafted for fear of being branded as abetting predatory lending—have since criticized the measure and have even stopped lending in the state.

Indeed, S.B. 1149 introduced profound changes to North Carolina's mortgage loan market—not only because it prohibits prepayment penalties on any loan less than $150,000, but also because it prohibits the lender from financing any points and fees. The legislators were aware that the prohibition against the financing of fees would reduce availability of credit to low-end borrowers. Accepting the premise that the subprime market plays a role of last resort for the credit-impaired borrower, one cannot help but wonder at what point consumer protection starts to trespass on consumer rights.

S.B. 1149 also did away with the financing of single-premium credit insurance for *all* consumer home loans, not just high-cost home loans. However, insurance premiums calculated and paid on a monthly basis are not considered as financed by the lender. Other states—notably, Illinois and Massachusetts—have followed North Carolina's lead and prohibited the practice, and recently major lenders such as

Citigroup and Household Finance have voluntarily abandoned the practice.

North Carolina S.B. 1149 forbade flipping, and most other states' antipredatory lending laws contain similar prohibitions. Significantly, however, another provision of S.B. 1149, which relates to all first-lien loans, prohibits prepayment penalties on any loan that is $150,000 or less. Extending the prohibition of prepayment penalties in S.B. 1149—to a broader universe of borrowers—was significant for investors, as subprime loans prepay faster than prime loans because borrowers have multiple incentives to refinance. The borrower may want to refinance if rates go lower. The borrower may refinance for debt consolidation or other financial need. The borrower may refinance if his or her credit improves. Another provision of S.B. 1149 forbids prepayment penalties if the borrower's debt-to-income ratio is higher than 50 percent, the borrower refinances through the same lender or the loan is more than five years seasoned.

North Carolina did not opt out of the Alternative Mortgage Transaction Parity Act (AMTPA). (Maine, Massachusetts, New York and South Carolina have opted out completely, and therefore the Parity Act will not override their laws restricting prepayment penalties. Wisconsin and Arizona have opted out for a narrow group of loan products and, hence, it is likely that the pre-emptive authority of the Parity Act would apply. The due diligence provider should examine the loan documents for the other states for authorization of the holder to impose prepayment charges. If the loan documents do not authorize such charges, the borrower may prepay the loan without paying a charge regardless of the Parity Act.)

However, the North Carolina Office of the Commissioner of Banks and the state's Attorney General's Office strongly oppose federal pre-emption and take the position that AMTPA does *not* pre-empt the provision that prohibits prepayment penalties on all first-lien loans in amounts of $150,000 or less, according to Daniel E. Garner, agency legal specialist for the Commissioner of Banks. They even take the position that federally chartered thrifts and national banks may not pre-empt this prohibition, which some legislative attorneys might find dubious. Nevertheless, to play it safe, investors should not accept North Carolina loans in which AMTPA has been used to pre-empt the North Carolina restriction on prepayment penalties.

There is evidence to suggest that, following a brief decline in the aftermath of S.B. 1149, the subprime market recovered.

The writers of S.B. 1149 focused attention at the front of the mortgage pipeline, at origination. S.B. 1149 established lower thresholds than HOEPA to prevent originators from escaping HOEPA coverage by making loans that evade the federal thresholds. The law's chief feature is regulation of prepayment penalties, one of the three thresholds for determining a high-cost home loan in North Carolina. A loan is deemed a high-cost home loan if it meets one of the following thresholds:

- If the APR at consummation is more than 10 percent higher than the yield on a Treasury security of comparable maturity on the 15th day of the previous month;
- If the points and fees are 5 percent for a loan with a balance of more than $20,000, or the lesser of 8 percent or $1,000 for a loan with a balance equal to or less than $20,000; or
- If the loan has prepayment penalties and is more than 30 months seasoned or the prepayment penalty fees, in the aggregate, are more than 2 percent of the amount prepaid, or (and this pertains to all consumer loans in North Carolina) if the loan has prepayment penalties and is equal to or less than $150,000.

With respect to disclosures, in addition to TILA and HOEPA disclosures, all borrowers must receive homeownership counseling from a counselor approved by the North Carolina Housing Finance Agency (NCHFA) prior to entering into a North Carolina high-cost home loan. Neither the Commissioner of Banks nor the NCHFA has prescribed a particular disclosure form to use in connection with this requirement. However, regulators at the Commissioner of Banks have indicated that the applicant's file must evidence such counseling was provided and that the applicant and the approved housing counselor signed off on the counseling. Clearly, secondary-market investors must ensure that this disclosure is in the file before purchasing a North Carolina high-cost home loan.

Violation of any of the prohibitions of S.B. 1149 exposes the investor to penalties for usury, which is forfeiture of all interest and return of twice the interest paid. Violation is also considered an unfair or deceptive act or practice, which subjects the holder to treble damages. The state's attorney general, Commissioner of Banks and any party to a high-cost home loan may bring an action for damages under the statute.

Any person seeking to enforce violations of the statute may recover damages under either the usury law or the deceptive practices statute—but not both. The statute does not impose any assignee liability per se, but because the violation of the statute renders the loan usurious and a deceptive practice, the borrower would presumably have recourse against a secondary-market purchaser of the loan.

There is evidence to suggest that, following a brief decline in the aftermath of S.B. 1149, the subprime market has recovered. GMAC/Residential Funding Corporation (GMAC-RFC), Bloomington, Minnesota, a lead issuer of subprime mortgage securities, saw its volume in North Carolina decline by 12.4 percent in 2000, while its total subprime volume declined only 5.7 percent according to *Inside Mortgage Finance*. In contrast, for the first nine months of 2000, FHA volume in North Carolina was off 15.9 percent, while nationwide, FHA issuance declined 23.6 percent.

GMAC-RFC continues to include North Carolina subprime loans in its deals in 2001. According to *Inside Mortgage Finance*, Option One Mortgage, Irvine, California; EquiCredit, a Jacksonville, Florida–based unit of Bank of America, Charlotte, North Carolina; and CitiFinancial, the Charleston, West Virginia–based consumer lending arm of the New York bank, have continued to originate high-cost home loans in North Carolina since passage of S.B. 1149.

Even Countrywide, Calabasas, California—which vowed to

pull out, saying that the state's law made it too difficult to do business—appears not to have entirely abandoned its North Carolina operations. In addition, the North Carolina Association of Realtors reported home sales in North Carolina declined only marginally from 1999 levels and are one-third less than the nationwide decline for the same period. Further, the Commissioner of Banks reports there has been no decline in mortgage broker licenses since the law was passed, and lending by banks and thrifts remains steady.

New York State

The Delta Funding Corporation settlement riveted national attention on predatory lending issues in New York state. Delta Funding, Woodbury, New York, used to originate more than $1 billion in loans annually and was one of the largest subprime lenders in the country. However, all that changed on June 22, 1999, when New York State attorney General Eliot Spitzer brought a complaint against Delta Funding for alleged violations of New York state's Fair Credit Law. The Department of Justice and the U.S. Attorney for the Eastern District of New York investigated Delta, focusing on the firm's operations in Brooklyn and Queens, where the company makes about one-quarter of its annual total of loans, primarily in minority neighborhoods.

The federal government (the Federal Trade Commission [FTC], Department of Justice and HUD) brought a suit against Delta in the first federal action of its kind to allege violations of HOEPA, RESPA, the Fair Housing Act and ECOA by the same lender.

According to the New York Banking Department, Delta Funding originated more than 1,000 high-cost home loans to low-income, minority residents over a three-year period. Delta made loans without regard for the borrower's ability to repay; approved and funded home mortgage loans to African-American females with higher mortgage broker fees than for similarly situated white males; and paid kickbacks and unearned fees to brokers to induce them to refer loan applicants to Delta, according to the charges.

According to the FTC, Delta engaged in a pattern of asset-based lending—refinancing loans based on collateral value while failing to take into account debt-to-income ratios, residual income or payment history. The FTC further accused Delta of charging prepayment penalties and of ruinous default rates.

Delta Funding settled the suit for $12 million on September 17, 1999, the day it was brought, in an agreement that averted the filing of a major civil-rights lawsuit by the attorney general in federal court. Interestingly, the New York Attorney General's Office and the Banking Department zealously vied with each other for jurisdiction over the explosive Delta Funding matter. Delta was forced to pay settlement fees into a restitution fund for injured borrowers, to submit to compliance monitoring for three years and to end a number of practices, such as yield-spread premium payments to brokers.

The Delta agreement was the largest settlement ever negotiated with a financial services company for its lending practices, and is the first ever of its kind negotiated with a mortgage lender.

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In the aftermath of the Delta Funding settlement and the increased scrutiny of predatory lending practices, the New York State Banking Department modified Part 41 of the General Regulations of the Banking Board Restrictions and Limitations on high-cost home loans in 1999.

The Banking Department, the governor's office and the mortgage industry negotiated for the better part of a year and a modified Part 41 was released and went into effect on October 1, 2000. The purpose of Part 41 was, among other things, to extend protections to the borrower by enhancing the tools available to prevent and punish unscrupulous or fraudulent lending practices related to advertising, brokering and the making of high-cost home loans. In addition to forbidding churning, financing of points and fees to a third party, flipping and making loans without regard to the borrower's ability to repay, Part 41 imposed new disclosures and reporting requirements upon lenders making high-cost home loans in New York state. According to Part 41, a loan is deemed predatory if it meets the following thresholds:

- The loan is a residential first-mortgage lien issued to an individual borrower for an owner-occupied dwelling, and the APR at consummation is more than 10 percent higher than the yield on a Treasury security of comparable maturity on the 15th day of the previous month;
- The loan is a residential junior lien issued to an individual borrower for an owner-occupied dwelling, and the APR at consummation is more than 9 percent higher than the yield on a Treasury security of comparable maturity on the 15th day of the previous month; or
- The points and fees exceed 5 percent of the loan balance.

In addition to disclosures that originators are required to give the borrower in writing pursuant to Part 38 of the General Regulations of the Banking Board at least three business days prior to closing, there are new Part 41 disclosures. At the time of application or before, the originator must disclose to the borrower that although his or her aggregate monthly debt payment may decrease, the high-cost home loan may increase both the borrower's aggregate number of monthly debt payments and the aggregate amount paid by the borrower over the term of the loan. In the event of a telephone application, the disclosure must be made immediately after receipt of the application by telephone but, in any event, at least three days prior to the closing. To utilize electronic transmission, the lender or broker must first obtain either written or electronically transmitted permission from the borrower.

Additionally, the loan application must also include this statement, in 12-point type above the borrower's signature line: "The loan which will be offered to you is not necessarily the least-expensive loan available to you, and you are advised to shop around to determine the comparative interest rates, points and other fees and charges."

Further, the New York state regulations require that a lender or mortgage broker deliver, place in the mail, fax or electronically transmit the following notice in at least 12-point type to the borrower at the time of application: "You should consider financial counseling prior to executing loan documents. The enclosed list of counselors is provided by the New York State Banking Department."

From the investor's point of view, buying a high-cost home loan in New York is safer than buying a high-cost home loan in North Carolina. There is no assignee liability, as the Banking Department that implements the regulations does not have authority over the secondary market.

The Banking Department may assess civil money damages against lenders that violate Part 41, and is authorized to take other enforcement action such as revocation of a mortgage license. Importantly, however, the validity of the loan is not impaired by a violation of the regulations. Notwithstanding the lack of assignee liability provisions, for reputation reasons secondary-market purchasers do not want to purchase loans that violate the regulations.

New York has a large lender community, a powerful press and an active subprime market that is funded in large part by Wall Street. Frustrated by her inability to regulate the secondary market, which is viewed as the source of funding for predatory lenders, New York Superintendent of Banks Elizabeth McCaul tried without success to impose on investment bankers certain loan-level due diligence standards for the loans they purchase in the secondary market and ultimately securitize.

McCaul suggested the adoption of due diligence best practices, which she circulated for comment to certain large Wall Street investment banks in the fall of 2000. After much discussion, the Banking Department and these Wall Street firms were unable to formulate a mutually agreeable policy statement. Wall Street firms feared that the adoption of such standards could expose them to possible securities law liability and private plaintiffs' litigation.

The New York Regulations currently in effect do not address assignee liability. However, Alan Hevesi, comptroller and a Democratic mayoral candidate, announced on June 8, 2001, that he would introduce antipredatory legislation (S. 5635) to the New York state legislature. S. 5635 fills in the gaps left by Part 41. Among the provisions of S. 5635, underwriters, sellers, securitizers or purchasers of high-cost home loans must certify that they have "implemented due diligence standards that are reasonably adapted to avoid the purchase, sale, underwriting or securitization of predatory loans."

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Massachusetts

The Massachusetts Division of Banks' final version of High Cost Mortgage Regulations became effective on March 22, 2001. A hybrid of the North Carolina law and New York state regulations, the Massachusetts regulations have the most far-reaching consequences of any of the state antipredatory statutes. Patterned after North Carolina's S.B. 1149 and passed into law after New York's Part 41, Massachusetts' regulations extend the scope of HOEPA and impose upon the market the harshest industry prohibitions to date.

What differentiates Massachusetts from other states, with respect to consumer issues, is that Massachusetts has adopted its own TILA and Regulation Z, which are at least as broad as the federal statute and regulation. The significance of the new Massachusetts regulations is that it substantially augments Massachusetts' existing provisions addressing high-cost home mortgages and renders assignees of Massachusetts high-cost home loans subject to the same penalties that could be further asserted against the originator.

Importantly, material violations of the High Cost Mortgage Regulations could impair the validity of the loan. In addition, the Massachusetts statute of limitations for TILA rights of rescission claims (which would be applicable to breaches of the new High Cost Mortgage Regulations) is four years—one year longer than the federal statute of limitations. In other words, the existing 209 CMR 32.32, which was the Massachusetts version of the federal Regulation Z provisions implementing HOEPA, has been replaced, effective March 22, 2001, by the new provisions of the High Cost Mortgage Regulations.

A high-cost home loan is defined as a closed-end consumer credit transaction secured by the consumer's principal dwelling, but not a reverse mortgage or an unsecured, open-end line of credit. So defined, a loan is deemed predatory in Massachusetts if it meets the following thresholds:

- The loan is a residential first-mortgage lien issued to an individual borrower for an owner-occupied dwelling, and the APR at consummation is more than 8 percent higher than the yield on a Treasury security of comparable maturity on the 15th day of the previous month;
- The loan is a residential junior lien issued to an individual borrower for an owner-occupied dwelling, and the APR at consummation is more than 9 percent higher than the yield on a Treasury security of comparable maturity on the 15th day of the previous month; or
- Total points and fees payable by the consumer at or before loan closing may not exceed the greater of 5 percent of the total loan amount or $400 adjusted for inflation, provided that bona fide discount points are deducted.

In addition to HOEPA-like disclosures that lenders must present to borrowers at application, Massachusetts imposes other disclosure requirements. It requires that the following statement appear in at least 12-point type directly above the borrower's signature line on the application: "The loan which will be offered to you is not necessarily the least-expensive loan available to you, and you are advised to shop around to determine competitive interest rates, points and other fees and charges."

The lender must also deliver, place in the mail, fax or e-mail to the borrower a statement in substantially the following form: "Although your aggregate monthly debt payment may decrease, the high-cost home loan may increase both your aggregate number of monthly debt payments and the

aggregate amount paid by you over the term of the loan."

There also must be a counseling disclosure and list of counselors that was provided to the borrower. A lender must deliver, mail, fax or e-mail a notice in at least 12-point type to the borrower at the time of application that says: "You should consider financial counseling prior to executing loan documents. The enclosed list of counselors is provided by the Division of Banks or the Executive Office of Elder Affairs."

At or prior to closing, the lender must either obtain evidence that the borrower has undergone financial counseling or, if the borrower has decided not to seek financial counseling, there must be a waiver in the file, signed by the borrower, indicating that the borrower was advised of his or her right to counseling and chose not to exercise that right.

Significantly, Massachusetts' points and fees triggers include yield-spread premiums (not the case in North Carolina and New York, as of this writing), which are payments to the broker from the lender for originating and processing a loan with a higher-than-par interest rate. Yield-spread premiums are included in the interest rate of the loans. Therefore, to include it again in the points and fees is double-counting. So in Massachusetts, as in other states whose antipredatory bills include yield-spread premiums in points and fees, loans with yield-spread premiums may hit predatory thresholds even though they are not truly high-cost home loans.

Prepayment penalties may only be imposed if the loans are three or fewer years seasoned; the source of prepayment funds is not a refinancing by the creditor or its affiliate; and at consummation, the borrower's debt-to-income ratio is 50 percent or less.

In addition to restrictions on prepayment penalties, the regulations also prohibit requiring a mandatory arbitration clause or waiver of participation in a class action that is oppressive, unfair, unconscionable or substantially in derogation of the rights of consumers. It is prohibited to make a high-cost home loan that contains single-premium credit insurance, including credit life, debt cancellation and debt suspension.

For loans excluding refinances (purchase-money mortgages, closed-end lines of credit and secured, open-end lines of credit), a lender may not require a borrower to finance any portion of the point and fees payable to third parties in an amount exceeding 5 percent of the principal amount of a closed-end loan or the maximum lien of an open-end line of credit. For refinances, financing of points and fees must not exceed 5 percent (less taxes, insurance and appraisal and credit fees) of the cash taken out. A lender may not finance voluntary unemployment insurance in connection with making a high-cost home loan unless the underwriting is based on the borrower's W-2 or 1099. A lender may not finance property insurance and/or voluntary insurance unless, in addition to not exceeding the 5 percent cap, the borrower's debt-to-income ratio is 50 percent or less.

There are a number of other prohibitions or requirements in the Massachusetts regulations. One of these is that the lender must reasonably believe at the time the loan is consummated that the borrower will be able to make the scheduled payments. There is a presumption of repayment ability if the borrower's debt-to-income ratio, including the new loan, is 50 percent or less. This provision, however, only applies to borrowers whose income does not exceed 120 percent of the median family income of the borrower's MSA. Parenthetically, due diligence firms must have online access to MSA median income data to verify compliance with this provision.

Antipredatory lending legislation, at the state and local level, is here to stay and will proliferate.

If North Carolina S.B. 1149 is referred to as the prepayment bill, then Massachusetts' High Cost Mortgage Regulations should be called the investor bill.

The regulations became effective too recently (March 22, 2001) to gauge market response. However, few investors are aware of the risk to the assignee or of the extended claims period, and both are likely to dampen investor demand in the future. The regulations make assignees of Massachusetts' high-cost loans subject to the same penalties that could be asserted against the originator. Again, material violations of the High Cost Mortgage Regulations could impair the validity of the loan, and they do extend the TILA rights of rescission to four years—as compared with the three-year federal claims period.

Future antipredatory lending legislation

Antipredatory lending legislation, at the state and local level, is here to stay and will proliferate. In the absence of a single federal standard—not likely anytime soon—the dizzying maze of state and local bills, regulations and ordinances will intensify and become ever more treacherous to navigate.

There are already 13 other states, counties and cities with effective laws that, due to space constraints, we have not discussed here. Texas; Connecticut; Cook County, Illinois; DeKalb County, Georgia; Dayton, Ohio; and Chicago are the most important of these. Then, we should mention new legislation in the pipeline, including two new bills in North Carolina, two bills in New York and at least three bills in California—the list goes on.

Against this backdrop, it is critical that both the originator and the investor plot a course to keep current with emerging law. They must develop relationships upon which they can depend for reliable legal information and counsel. And they must be in a position to demand the proper degree of due diligence from providers that can deliver it. The stakes are too high to go it alone. And every day the stakes are getting that much higher. **MB**

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