The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act") has been called the most significant overhaul of our nation's financial system since the Great Depression. The following is one in a series of practical summaries of certain provisions of the Act that may be of interest to financial institutions. Please feel free to contact us with any questions regarding this summary.

The Dodd-Frank Act requires new disclosures and other significant changes to how banking organizations conduct residential mortgage lending. Your company should evaluate these changes to determine how best to bring your existing mortgage lending policies and procedures into compliance with these requirements. The requirements summarized below are not yet effective, but may become effective as soon as early 2012.

Minimum Standards for Residential Mortgage Loans

Under the Act, certain new consumer residential mortgage loans, including first and second mortgages, must meet certain minimum standards, such as:

- <u>Ability-to-Pay Requirements (No "Liar Loans")</u>. Lenders cannot make a consumer residential mortgage loan without determining in good faith the borrower's ability to repay the loan, based on certain verified documentation. A lender's failure to abide by this standard can give rise to an assertable defense by a defaulting homeowner in a foreclosure action, ***regardless of the statute of limitations***. There is a rebuttable presumption that a mortgage loan meets the ability-to-pay requirements if it meets specified standards governing rates and terms making it a "Qualified Mortgage."[1]

- <u>Prepayment Penalty Restrictions</u>. Prepayment penalties are prohibited from being applied to any residential mortgage loans, except for certain types of "Qualified Mortgages." Even for the specified Qualified Mortgages for which a prepayment penalty may be authorized, the prepayment penalty cannot exceed 3%, and this limit decreases annually, with no prepayment penalties authorized after the third year of such a loan. Also, if a lender offers a consumer a mortgage containing a prepayment penalty, it must also offer one ***without*** a prepayment penalty.

- No Financing of Lump-Sum Credit Insurance. Lenders may no longer finance single-pay premium credit insurance with residential mortgage loan funds.

- No Mandatory Arbitration. The consumer mortgage loan documents cannot include provisions requiring arbitration or other non-judicial dispute resolution methods.

- Additional Disclosures. The Act requires many new disclosures and notices. Several of these new disclosures and notices are required in closing documentation, as well as in periodic statements to loan customers. Examples include disclosures and notices regarding:
    - Settlement charges
    - Compensation to mortgage originators (eg., banks, bank employees, brokers)
    - Interest payments as a percentage of principal
    - Negative amortization
    - Anti-deficiency laws
    - Hybrid adjustable rate mortgages

[1] A loan is a "Qualified Mortgage" if it meets all of the following requirements: (a) has either a fixed rate or an adjustable rate underwritten with a maximum interest rate during the first five years of the loan; (b) adheres to strict limitations on balloon payments; (c) includes verified and documented income and financial sources for borrowers; (d) has an escrow account for applicable taxes, insurance, and assessments; (e) complies with published guidelines regarding borrower debt-to-income ratios; (f) has points and fees that meet certain limitations, but in no instance exceed 3% of the total loan amount; and (g) has a term of 30 years or less.

Mortgage Loan Originators – Prohibited Conduct

The Act prohibits mortgage originators which directly or indirectly arrange consumer residential mortgage loans for their customers from engaging in certain practices. These prohibitions include items such as:

- No "Steering" Incentives
    - Mortgage originators cannot steer a consumer to a loan for which:
        - The borrower lacks the reasonable ability to repay, or
        - Contains predatory characteristics or effects (equity stripping, excessive fees, abusive terms, etc.)
    - Mortgage originators cannot steer a consumer away from a "Qualified Mortgage" (for which he or she qualifies) to an "Unqualified Mortgage"
- No mischaracterization of borrower credit history
- No mischaracterization of property value (or pressure for appraiser to do so)

Likewise, the Act prohibits certain mortgage originator compensation structures, such as Yield Spread Premiums, which vary based on loan terms other than the principal amount of the mortgage. Also, only the consumer borrowers may pay origination fees to mortgage originators.

Limits on Interaction with Appraisers

The Act provides for various independence standards regarding real estate appraisals, which will prohibit banks from engaging in certain coercive conduct, for

example, encouraging mischaracterization of appraised value, influencing an appraiser to encourage a targeting value and other types of coercion. Additionally, "Higher Risk Mortgages" as defined under the Act, must have a written appraisal which includes a physical inspection of the interior of the home.[2]

[2] The Act defines a "Higher-Risk Mortgage" as an "unqualified" mortgage with an APR exceeding the "average prime offer rate" as published by federal regulatory authorities by: (a) at least 1.5% for Fannie Mae and Freddie Mac conforming first mortgages, (b) at least 2.5% for first mortgages exceeding the Fannie Mae and Freddie Mac limits, and (c) at least 3.5% for second or further subordinate mortgages. This definition is different than the Act's definition for "High-Cost Mortgage" as described below.

High-Cost Mortgage Restrictions

The Dodd-Frank Act redefines the Home Ownership Equity Protection Act definition of a "High-Cost Mortgage" to be a consumer mortgage which contains any of the following elements:

- An APR which is at least:
  - 6.5% over the "average prime offer rate" as published by federal regulatory authorities (first mortgages), or
  - 8.5% over the "average prime offer rate" (second mortgages or first mortgages less than $20,000);
- Total points and fees exceed:
  - 5% of the loan amount (for $20,000+ loans), or
  - 8% of smaller loan amounts (with a floor of $1,000); or
- Prepayment penalties in excess of 2% over the amount prepaid.

High-Cost Mortgages carry several new restrictions, such as:

- Strict limitations on balloon payments
  - Only two times the amount of a regular payment is allowed as a balloon payment
- Limitations on late fees
- Limitations on acceleration
- No financing of points and fees
- Mandatory loan counseling - The Office of Housing Counseling (the "OHC"), established by the Act as part of HUD, will license individuals to provide this mandatory loan counseling.

Effective Date

The provisions of the Act discussed above are set to become effective 12 months after regulatory authority is granted to the new "Consumer Financial Protection Bureau." This grant of authority may occur as soon as early 2011, making the effective date of the Act's mortgage lending provisions potentially as soon as early 2012.

If you have further questions regarding the Dodd-Frank Act, you may contact one of the Thompson Coburn Attorneys listed below:

Peter A. Fanchi	View Resume	pfanchi@thompsoncoburn.com
Thomas B. Kinsock	View Resume	tkinsock@thompsoncoburn.com
Robert M. LaRose	View Resume	rlarose@thompsoncoburn.com
Gregory D. Omer	View Resume	gomer@thompsoncoburn.com
Jason B. Hill	View Resume	jhill@thompsoncoburn.com

Visit our Business/Transactional attorneys online.

Thompson Coburn LLP

Chicago | St. Louis | Southern Illinois | Washington, D.C.

www.thompsoncoburn.com
